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June 2, 2019

Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2019-30) Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2019-30, 2019-2020 Priority
Guidance Plan

Dear Sir or Madam:

The undersigned, Jeff Kadet and David Koontz, are retired CPAs who have worked both domestically and internationally for many years. Based on our prior working experience and in connection with some recent articles we have written, we have identified several projects that we believe should be considered a *high priority* for the Treasury and the IRS. These projects, which are attached as appendices to this letter, cover a number of areas.

Notice 2019-30 lists factors that the Treasury and the IRS consider in selecting projects for inclusion in its 2019-2020 Priority Guidance Plan. They include, for example, whether a project (i) involves significant issues relevant to many taxpayers, (ii) will reduce controversy and lessen the burden on taxpayers or the IRS, and (iii) promotes sound tax administration.

All of the suggestions for projects that we are submitting more than satisfy all of these factors. More specifically, the effect of issuing new and/or amended regulations as well as publishing guidance in these areas would create a fairer and more level playing field between the IRS and all taxpayers, including particularly multinational corporations (MNCs) that have enjoyed increasing informational and resource advantages over the government in recent years. Our suggestions would allow our tax laws to be fairly enforced and achieve the results intended by Congress.

A principal focus of our suggestions is the modernization and updating of regulations as well as providing guidance that will affect all taxpayers. With respect to MNCs whose operations take place partially or wholly within the U.S., many have embarked on complicated and legalistic schemes, some of which have as a primary purpose the shifting of profits without any meaningful operational changes. Under these schemes, these MNCs record much or most of their profits within zero- and low-taxed foreign group members. Importantly, this includes not only U.S.-based MNCs, but also the many inverted MNCs that structured their inversions to remain untouched by the §7874 anti-inversion rules.

The government has expended efforts and significant resources attempting to attack a multitude of MNC profit shifting structures. These efforts are labor intensive, time consuming, and have uncertain outcomes for all parties. Such attacks have relied on either transfer pricing (e.g. Microsoft, Amazon, Facebook, etc.) or re-characterization adjustments (e.g. Caterpillar, Perrigo, etc.).

Certain of our suggested updating and modernizations focus on the Code's sourcing and effectively connected income (ECI) rules as well as its entity classification rules. We believe that updated and modernized rules will give the Treasury and IRS additional tools that, where applicable, have the potential to be objective, fact-based, and easy to apply. They can be an important supplement to the transfer pricing and re-characterization tools now commonly used.

The recent Tax Cuts and Jobs Act (P.L. 115-97) has made substantial changes in how the U.S. taxes foreign income and foreign activities. However, like pre TCJA law, one effect of the §245A dividend received deduction and the lower effective tax rate on Global Intangible Low-Taxed Income is that it left in place an up to ten-percentage point or higher incentive to continue the above-mentioned schemes. It is in this context that we believe that parts of the new law need clarification and that existing law requires modernizing regulations.

The issuance by the Treasury and the IRS of modernized sourcing and ECI regulations along with our entity classification and other suggestions focused on profit shifting structures would provide clarity for both MNC taxpayers and the IRS.¹ In addition, clear

¹ These high priority regulation projects (with perhaps the sole exception of the TCJA change to the §863(b) sourcing rule) represent only modernization and clarification of *existing* rules that are already sufficiently broad to apply ECI taxation and partnership status to many profit shifting structures. Importantly, the Treasury and IRS should make clear that these rules will apply where the facts support them to any tax year whether before or after the issuance of new or amended regulations.

guidance would assist outside audit firms in providing guidance to their clients to make more meaningful disclosures of potential tax liabilities or to accrue tax, interest, and penalties where some clients may have inappropriately pushed the envelope in their profit shifting structures. This would be further helped by the IRS designating tax motivated structures having relevant factual, profit shifting characteristics as a “listed transaction”.

The undersigned either together or separately have authored six articles covering how various MNC profit-shifting structures may well be subject to U.S. taxation under the effectively connected income (ECI) rules. A seventh article is focused on the TCJA amendment of the §863(b) sourcing rule for inventory property that has been both produced and sold by the same taxpayer.² The third of these articles details how such structures often create an unanticipated partnership for U.S. tax purposes that includes two or more MNC group members as partners in a partnership that conducts the joint business of the group members. The sixth article notes how the manufacturing branch rule included in the Subpart F regulations may often apply to cause some gross income not caught by the ECI rules to be subpart F income. Additional background and issues relevant to suggestions made within this letter and its appendices are covered in detail in those articles.

Further, many MNCs erode the U.S. tax base through deductible payments by U.S. group members to foreign group members, including disregarded entity subsidiaries. Often, these payments would be subject to the 30% U.S. withholding tax, but this tax is most typically reduced or eliminated by the claimed coverage of a tax treaty. The same is true for non-withholding tax claims such as a claim by a foreign group member that it has no permanent establishment under an applicable tax treaty. Appendix H provides specific

² 1. Jeffery M. Kadet, “Attacking Profit Shifting: The Approach Everyone Forgets”, 148 *Tax Notes* 193 (July 13, 2015), available at <http://ssrn.com/abstract=2636073>.

2. Thomas J. Kelley, David L. Koontz, and Jeffery Kadet, “Profit Shifting: Effectively Connected Income and Financial Statement Risks”, 221(2) *Journal of Accountancy* 48 (February 2016), available at <http://ssrn.com/abstract=2728157>.

3. Jeffery M. Kadet and David L. Koontz, “Profit-Shifting Structures and Unexpected Partnership Status”, 151 *Tax Notes* 335 (April 18, 2016), available at <http://ssrn.com/abstract=2773574>.

4. Jeffery M. Kadet and David L. Koontz, “Profit-Shifting Structures: Making Ethical Judgments Objectively,” Part 1 at 151 *Tax Notes* 1831 (June 27, 2016) and Part 2 at 152 *Tax Notes* 85 (July 4, 2016), available at <http://ssrn.com/abstract=2811267> and <http://ssrn.com/abstract=2811280>.

5. Jeffery M. Kadet and David L. Koontz, “Internet Platform Companies and Base Erosion--Issue and Solution,” *Tax Notes*, Dec. 4, 2017, p. 1435, available at <http://ssrn.com/abstract=3096925>.

6. Jeffery M. Kadet and David L. Koontz, “Effects of New Sourcing Rule: ECI and Profit Shifting”, *Tax Notes*, May 21, 2018, p. 1119, available at <http://ssrn.com/abstract=3201365>.

7. Jeffery M. Kadet, “Sourcing Rule Change: Manufacturing and Competitiveness”, *Tax Notes*, November 5, 2018, p. 717, available at <http://ssrn.com/abstract=3296763>.

guidance for needed regulatory amendments that would prevent the inappropriate use of tax treaties to achieve double non-taxation.

We suggest that the Treasury and IRS make clear to all taxpayers its intention to pursue profit shifting structures through notices, revenue rulings, or regulations, as appropriate. We believe that that would draw the attention of boards of directors and managements of MNCs along with their legal and tax advisors, thereby causing some MNCs to scale back or even unwind existing structures, and to avoid initiating new ones. Note that clear indications of Treasury and IRS intentions would achieve one of the stated goals of the "Form 1120-F Non-Filer Campaign" released on January 31, 2017. That campaign states, in part:

... The goal is to increase voluntary compliance by foreign corporations with a U.S. business nexus.

* * * * *

We hope that the above information is useful to the Treasury and the IRS. Either of us would be glad to speak by telephone with you or to respond to emailed questions if that would be helpful.

Very truly yours,

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Attached Appendices

Appendix A – Modernization of Sourcing of Income and Effectively Connected Income Regulations (Regulations under §§861 - 864)

Appendix B – Section 863(b) including TCJA Amendment affecting Taxpayer-Produced Inventory Property under Paragraph (2)

Appendix C – Regulations Concerning §§865(e)(2) and (3)

Appendix D – Amendment of Reg §301.7701-1(a)(2) and/or Issuance of Revenue Ruling on Partnership Status for Certain Profit-Shifting Structures

Appendix E – Designate Certain MNC Profit-Shifting Structures as Listed Transactions

Appendix F – Profit-Shifting Structures Implemented Following Inversions and Acquisitions by Foreign Acquirers

Appendix G – Addition of Examples to the Manufacturing Branch Rule

Appendix H – Regulatory and Ruling Guidance Concerning Tax Treaties

APPENDIX A

Modernization of Sourcing of Income and Effectively Connected Income (ECI) Regulations (Regulations under §§861 - 864)

Problem: Existing income sourcing and ECI regulations are sufficient to determine, calculate, and impose ECI taxation for traditional (old) businesses but lack clarity when applied to new business models prevalent in the 21st century. These include large MNCs that depend on the use of digital and internet tools in their centrally managed worldwide business models (e.g. high-tech manufacturers, pharmaceutical companies, internet-based companies earning advertising and commission income, etc.). The existing regulations need modernization to provide the IRS with another and even more effective tool to use against profit-shifting structures. Currently, the IRS's primary tools to reverse profit-shifting structures have been transfer pricing and re-characterization, both tools that are very subjective to apply and uncertain of success in the complex litigation that inevitably follows. Modernizing the rules for applying ECI taxation would hopefully encourage taxpayers to avoid aggressive structures and effectively add another enforcement tool for the IRS to apply and sustain due to ECI's more objective, fact-based criteria.

Solution: It is critical that sourcing and ECI regulations be updated to reflect modern-day business models such as supply chains, contract manufacturers, etc. Moreover, updating these regulations and making them consistent with other parts of the Code and regulations would make ECI taxation easier for both taxpayers and the IRS to apply. Failing to up-date these regulations will likely result in situations where ECI taxation should apply but which may go unrecognized by taxpayers, outside auditors, and the IRS.

Regarding specific regulations to be modernized, the Reg. §1.864-6 rules (regarding sales of goods or merchandise through a U.S. office of a foreign taxpayer) focus closely on the sales contract and not on the many critical activities, often performed within the United States by related persons, that strongly support not only consummated sales but critical purchase and/or production functions. For example, many profit shifting structures start with the transfer of production intangibles to a zero- or low-taxed foreign group member that itself has no personnel or capacity to:

- Conduct production through its own facilities;
- Direct production physically performed by a contract manufacturer;
- Control the risks associated with production or the holding of the production intangibles.

Capacity to carry out these functions remains within one or more U.S. group members that act on behalf of the foreign group member. These U.S. group members conduct production operations, make day-to-day business decisions, and manage production risk for that foreign member. Such operations and decisions can include the contractual terms of agreements signed by the foreign member with component suppliers, raw material vendors, and contract manufacturers. It also includes decisions on production processes, production quantities, quality control, etc. Such functions and activities, and the

commercial risks that arise from them, are a crucial and critical part of any manufacturing business.

This sort of profit shifting structure, voluntarily created by many MNCs seeking to shift profits into zero- or low-taxed foreign group members, creates solely *in legal form* an independent company that produces products and sells them. Most or all production functions (short of the physical manufacture that is performed by a usually unrelated contract manufacturer) are performed by group members in the U.S., which are ostensibly acting as independent contractors under a service agreement and not as an agent, joint venturer, or partner.

Modernization of the §§861-864 regulations is needed to reflect the reality that U.S. group members are performing critical production functions and making day-to-day business decisions that control the potential profitability of and commercial risks borne by the foreign group member. Such modernization could include:³

- **Meaning of “Produced”**

Reg §1.864-1 should be amended to read:

For purposes of sections 1.861-1 through 1.864-7, the word "sale" includes "exchange"; the word "sold" includes "exchanged"; the word "produced" includes "created", "fabricated", "manufactured", "extracted", "processed", "cured", "aged", and activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property through the activities of a taxpayer's employees, agents, and related persons (within the meaning of section 1.954-1(f)).

- **Clarity of Engaged in Trade or Business within the United States**

Reg §1.864-2 should be amended to clarify that a foreign taxpayer having no capacity or personnel to conduct all or any material portion of its business or to manage the commercial risks of all or any material portion of its business will be engaged in trade or business within the U.S. when those functions or management of risks are conducted by one or more persons within the U.S. Such persons include not only agents of the foreign taxpayer, but also putative independent contractors (whether related or not) acting under a service or similar agreement.

The following should be added at the end of paragraph (a) of Reg §1.864-2:

The term also includes the performance of activities within the United States (for example the purchasing or production of products, the substantial contribution to the manufacturing of personal property within

³ The suggested modernizations included below assume the present regulation structure under §864 that have not yet been updated to reflect the addition of §865 and, in particular, §865(e)(2), which causes relevant sales of personal property to be U.S. source and therefore ECI under §864(c)(3) rather than foreign source and, as a result, covered by §864(c)(4)(B)(iii). See additional comments in Appendix C that provide some suggestions relevant if a decision is made to issue new regulations under §§865(e)(2) and (3).

the meaning of section 1.954-3(a)(4)(iv)(b), the sale of products, the maintenance and management of an internet-based platform through which sales are made or advertising or other internet based service revenues are earned, the rental or licensing of intangibles, etc.) by another person (whether related or not and including activities performed under any independent contractor service agreement or agency) who conducts all or any material portion of these activities or manages the commercial risks thereof for or on behalf of any taxpayer when the taxpayer itself has insufficient personnel or capacity to conduct all or any material portion of its business or manage the commercial risks thereof. The actual conduct and activities of the persons will be decisive rather than any contractual label or description that provides, for example, that the person conducting the activities or managing the commercial risk is an independent contractor providing a service.

- **Gross Income from Internet-Based Platforms**

Many MNCs and other taxpayers conduct centrally managed worldwide businesses that involve the provision of digital goods and services. At the core of these businesses are the central ongoing decision-making concerning the business being conducted and the day-to-day maintenance and management of the internet platforms that are accessed by users globally. For many MNCs, these platforms were not only developed primarily within the U.S., but both the ongoing decision-making and the platform maintenance and management are also conducted mostly, if not wholly, within the U.S. While users (including advertisers) from a particular country, territory, or region may access a platform presented in their local language with some localization of the products or services offered, the platform and the digital goods and services offered are virtually the same worldwide. It is MNC personnel located in the U.S. who maintain and manage these worldwide platforms and are the decision makers with regard to matters such as the products or services to be offered, the terms on which they will be offered including pricing, etc.

These digital goods and services include providing advertisers and others with access to the MNC's user base and information about users. They also include without limitation providing platforms for gig economy workers (e.g. ride sharing), acting as agents selling the products of others (e.g. software and non-physical products like ebooks, music, movies, etc.), and providing cloud services.

For some years now, the regularly issued Priority Guidance Plan has included a project focused on the sourcing and character of income related to digital goods and services. The most recent quarterly update issued on April 5, 2019, of the 2018-2019 Priority Guidance Plan in the International section on page 23 at F.2. states:

Regulations under §861 on the character of income, including income arising in transactions involving intellectual property and the provision of digital goods and services.

The authors of this submission have no information of what is being considered for these future regulations. However, we believe that where an internet platform and the business being conducted are primarily maintained and managed from within the U.S., future regulations will likely provide that some material portion of the revenue generated will be U.S. source gross income, irrespective of where in the world the user, advertiser, or customer may be.

For prior and current years until these contemplated regulations are issued, source of income will be based on the existing regulations, IRS rulings, other IRS pronouncements, and case law. While there of course can be arguments made for specific taxpayer situations regarding the character of income and the source rule to be used, it seems that often the facts and circumstances approach of Reg §1.861-4(b)(1) will be the most appropriate sourcing rule to apply. Where this is the case, the day-to-day U.S.-based maintenance and management of the group's business and internet platform will cause material amounts of U.S. source income, again irrespective of where in the world the user, advertiser, or other customer may be.

Many MNC profit shifting structures involve the license or transfer of IP created primarily within the U.S. to zero- or low-taxed foreign group members. Such transactions provide the basis for the foreign group members to record revenues generated by the internet platform from digital goods and services. A transfer often involves first an ownership transfer of existing IP along with a cost sharing agreement that allows the group member participants to own their respective shares of future IP development for exploitation within their respective geographic areas.

The foreign group member licenses or owns its IP, but it participates minimally, if at all, in the actual operation of the internet platform through which it earns its revenues from digital goods and services. Rather, one or more U.S. group members conduct within the U.S. the bulk or all of the maintenance and management of the business and platform for foreign group members (including management of risk of the group's investment in the platform), presumably under a service or similar agreement. The foreign group member's personnel (including the employees of any disregarded entity subsidiaries) are typically involved in marketing, customer support, logistics, and similar activities. They normally have neither the knowledge nor the capacity to participate in maintaining and managing the platform or in managing the risk of the IP they license or own. Further, they do not have the capability of directing an independent service provider to perform these functions and manage these risks.

In these circumstances, note that under Reg §1.482-7(j)(3)(i), cost sharing transaction payments will be considered the payor's costs of developing intangibles at the location where such development is conducted. Reg §1.482-7(j)(2)(ii) provides that a foreign participant in a cost sharing agreement will not be treated as engaged in trade or business within the U.S. solely by reason of its participation in a CSA. However, if other factors create a trade or business within the U.S., the paragraph (j)(3)(i) characterization rule means that the foreign participant is considered to directly own a share of an intangible asset (the internet

platform) that is maintained and managed on a day-to-day basis within the U.S. This means that the existing regulations characterize the foreign participant as earning gross income from “directly-owned” assets that are part of an active business being managed and conducted within the U.S. This characterization further supports that there must be some material amount of U.S. source income.

Under the first bullet point above, we have suggested a change to Reg §1.864-2(a) that would make clear that a foreign group member earning gross income from digital goods and services through an internet platform that is maintained and managed within the U.S. as described within this bullet point will be engaged in trade or business within the United States. We suggest that the following

Example (4) be added to Reg §1.864-4(b) to make clear that any U.S. source income earned by such a foreign group member would be effectively connected income. (An additional Example (5) concerning production activities conducted within the U.S. is included under the below bullet point “Income, Gain, or Loss Attributable to an Office or Other Fixed Place of Business in the United States – Purchasing and Production Functions”).)

Example (4). In 2005, U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) execute a cost sharing agreement (CSA) to develop digital goods and services, an internet platform, related software, and business processes for earning revenues worldwide from the sale, exchange, rental, lease, or similar transactions related to such digital goods and services. Under the CSA, each of USP and FS owns a share of the internet platform and holds the economic rights for exploitation of the developed IP within its respective geographic territory (for USP, North America, and for FS, the rest of the world). FS (including its disregarded entity subsidiaries) conducts marketing, customer service, logistics, and related activities within its territory. Under a service agreement, FS contracts with USP for USP to maintain and manage the internet platform that USP and FS jointly own. It is determined that the facts and circumstances of USP and FS cause FS to be engaged in trade or business within the United States under the provisions of section 1.864-2. FS’s income or loss from sources within the United States is treated as effectively connected for 2005 with the conduct of a business in the United States.

We noted above that prior Priority Guidance Plans have included a project focused on the sourcing and character of income related to digital goods and services. We also commented that until this new contemplated guidance is issued that the facts and circumstances approach of Reg §1.861-4(b)(1) may often be the most appropriate sourcing rule to apply to the sourcing of gross income from internet-based platforms. We do not know what position MNCs may or may not be taking with respect to the sourcing of such income. Perhaps this is normally a non-issue to them since such MNCs would also be maintaining that their zero- and low-taxed foreign group members have no U.S. trade or business. With no U.S. trade or business, even if their income is U.S. source under Reg §1.861-4(b)(1), there would be no ECI.

We have suggested changes earlier in this Appendix A that would expand the definition of U.S. trade or business for these internet-based platform businesses. This of course would make this sourcing issue very important. We suggest that until new regulations are issued under this existing Priority Guidance Plan project (i.e., the sourcing and character of income related to digital goods and services), that guidance be provided through a revenue ruling, notice, or other means that identifies the criteria to be used to determine the respective amounts of U.S. and foreign source income that arise when U.S.-based group members manage, direct, or conduct critical aspects of a foreign group member's internet platform-based business. For example, should the principles of Reg §1.861-4(b) apply? What other factors should be considered?

Office or Other Fixed Place of Business Within the United States

Amend Reg §1.864-7(c) by adding the following sentence at the end of this paragraph.

However, where the officers or other personnel of the domestic parent corporation are not only responsible for policy decisions affecting the related foreign sales corporation, but also conduct activities that represent the business of that foreign sales corporation (for example, officers or other personnel are involved in negotiations with major customers, approve the terms of specific sales contracts, manage or control the purchasing and sourcing of inventory property from vendors or from contract manufacturers, etc.) or manage its commercial risks, then that foreign sales corporation will be considered to have an office or other fixed place of business in the United States.

Amend Reg §1.864-7(g) by adding the following new Example (7) at the end of this paragraph.

Example (7). S, a foreign corporation, is engaged in the business of manufacturing a microphone and selling it to customers within its territory, which is all countries outside North America. S is a wholly owned subsidiary of P, a domestic corporation engaged in the business of manufacturing the same microphone and selling it to customers in North America. The physical manufacture of the microphone is performed by an unrelated contract manufacturer under separate contract manufacturing agreements that each of P and S have executed with the contract manufacturer. P and S have executed a cost sharing agreement (CSA) for the development of the microphone and the production processes to produce it.

Employees of P conduct the bulk of the development work under the CSA. They also conduct virtually all functions described in section 1.954-3(a)(4)(iv)(b), which represent a substantial contribution to the manufacture of the microphones. The performance of these functions is integral and necessary for both P and S to source their respective microphones from the contract manufacturer.

S does not have a fixed facility in the United States, and none of its employees are stationed in the United States. Officers and employees of P are generally responsible for the policies followed by S and are directors of S. S has a chief executive officer in Country A who, from its office therein, handles the day-to-day conduct of S's business. However, the chief executive officer does not have the knowledge or capability to perform the functions described in section 1.954-3(a)(4)(iv)(b) or to direct another person to do so. If P did not perform these functions, S would be incapable of either manufacturing, or having manufactured, the microphones for which it holds IP rights under the CSA.

Based upon the facts presented, S is considered to have an office or other fixed place of business in the United States for purposes of this section.

- **Income, Gain, or Loss Attributable to an Office or Other Fixed Place of Business in the United States – Purchasing and Production Functions**

Reg. §1.864-6, which in part concerns sales of goods or merchandise through a U.S. office of a foreign taxpayer, focus closely on the sales contract and not on the many critical activities, often performed within the United States by related persons, that strongly support not only consummated sales but critical purchase and production functions. We recommend amending the first sentence of Reg §1.864-6(b)(2)(iii) to read as follows:

Income, gain, or loss from sales of goods or merchandise specified in paragraph (b)(3) of section 1.864-5, if the office or other fixed place of business is involved in purchasing such goods or merchandise, conducts production activities with respect to such goods or merchandise (within the meaning of section 1.954-3(a)(4)(i), including activities described in paragraph (4)(iv)(b)), or actively participates in soliciting the order, negotiating the contract of sale, or performing other significant services necessary for the consummation of the sale which are not the subject of a separate agreement between the seller and the buyer.

The effect of this amendment is best illustrated by an example. Say that a zero- or low-taxed foreign group member sells products through an internet platform that is maintained and managed by a U.S. group member. The U.S. group member could also conduct certain product purchasing functions for the foreign group member. Assume that the foreign group member does not have any foreign office that is a material factor in the realization of income (see Reg §1.864-6(b)(3)(i)). Assume also that the foreign group member through its own employees (including the employees of any disregarded entity subsidiary) does not perform any product purchasing functions.

Under the current regulation, the foreign group member takes the position that neither the operation of the internet platform nor the purchasing activities conducted by the U.S. group member cause the sales income to be attributable to an office or fixed place of business within the U.S. This means that even with no foreign office that is a material factor in the realization of income and with no

purchasing activities performed by the foreign group member, the gross income from sales will not be ECI.

With the suggested amendment of the first sentence of Reg §1.864-6(b)(2)(iii) (and the other suggested regulatory changes included in this submission), it will be clear that the sales income will be attributable to an office or fixed place of business within the U.S. Once this “attributable to” condition is met, the sales income will be U.S. source income under §865(e)(2) and ECI under §864(c)(3).

In recognition of the regulation updating necessary due to the TCJA amendment of §863(b), we suggest that the following Example (5) be added to Reg §1.864-4(b). We have drafted it to be relevant both before and after the TCJA §863(b) amendment.

Example (5). In 2005, U.S. Parent (USP) and its wholly owned Foreign Subsidiary (FS) execute a cost sharing agreement (CSA) for product P. Under the CSA, each of USP and FS owns its share of the economic rights for exploitation of the IP for product P within its respective geographic territory (for USP, North America, and for FS, the rest of the world). FS (including its disregarded entity subsidiaries) conducts marketing, customer service, logistics, and related activities within its territory. Under a service agreement, FS contracts with USP for USP to provide services and other activities that contribute to FS’s production of product P. These services and other activities include selection of and negotiation with vendors of product P components and contract manufacturers for production services. The services and other activities also include product P production planning and management involving, for example, quantities of production, control of inventory levels of raw materials, work-in-progress, and finished goods, quality control, and other functions listed in section 1.954-3(a)(4)(iv)(b). It is determined that the facts and circumstances of USP and FS cause FS to be engaged in trade or business within the United States under the provisions of section 1.864-2 and that FS has U.S. source income under section 863(b) since the location of manufacture is partially or wholly within the United States. FS’s income or loss from sources within the United States is treated as effectively connected for 2005 with the conduct of a business in the United States.

- **Income, Gain, or Loss Attributable to an Office or Other Fixed Place of Business in the United States – Reg §1.864-6(c) and §§865(c)(2) and (3)**

Reg §1.864-6(c)(2) presently reflects pre-§865 law. Following the addition of §865(e)(2), which defines certain otherwise foreign source income as U.S. source income, it is important to both update this regulation and provide within the updated section a clear statement of Treasury’s position that the “properly allocable” language of §865(c)(5)(C) still applies following the TCJA §863(b) amendment regarding the sourcing of income from the sale or exchange of taxpayer-produced inventory property. See discussion in Appendix C – Regulations Concerning §§865(e)(2) and (3) wherein we state our expectation that Treasury would adopt this “properly allocable” interpretation.

With the above in mind, we suggest the following language for an amended and updated Reg §1.864-6(c)(2) and (c)(3).

(2) Special rule for sales of goods or merchandise through U.S. office.

Notwithstanding subparagraph (1) of this paragraph, in the case of any sale of inventory property that is attributable to an office or other fixed place of business that a nonresident alien or foreign corporation maintains in the United States, which is not a sale to which section 865(e)(2)(B) applies, the amount of income which shall be attributable to the office or other fixed place of business which the nonresident alien individual or foreign corporation has in the United States shall be the amount which is properly allocable to that office or other fixed place of business. See, for example, paragraph (b) of section 1.863-3 as in effect for taxable periods beginning on or before December 31, 2017, which prescribes, as available methods for determining income from production activity and sales activity, the 50/50 method, the independent factory price method, and the books and records method.

(3) Illustrations

The application of this paragraph may be illustrated by the following examples:

Example (1). Foreign corporation M manufactures machinery in a foreign country and sells the machinery outside the United States through its sales office in the United States for use in foreign countries. Title to the property which is sold is transferred to the foreign purchaser outside the United States, but no office or other fixed place of business of M in a foreign country participates materially in the sale made through its U.S. office. Under section 865(e)(2), income from M's sale of machinery attributable to its sales office is sourced in the United States. During the taxable year M derives a total taxable income (determined as though M were a domestic corporation) of \$250,000 from these sales. Using the independent factory price method, the taxable income from sources within the United States from such sales is determined to be \$100,000. The taxable income which is allocable to M's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business within the United States by that corporation is \$100,000.

Example (2). Foreign corporation N has an office in a foreign country which purchases merchandise and sells it through its sales office in the United States for use in various foreign countries, such sales being made outside the United States and title to the property passing outside the United States. No other office of N participates materially in these sales made through its U.S. office. Under section 865(e)(2), income from N's sale of merchandise attributable to its sales office is sourced in the United States. By reason of its sales activities in the United States, N is engaged in business in the United States during the taxable year. During the taxable

year N derives taxable income (determined as though N were a domestic corporation) of \$300,000 from these sales made through its U.S. sales office. The taxable income which is allocable to N's U.S. sales office pursuant to this paragraph and which is effectively connected for the taxable year with the conduct of a trade or business in the United States by that corporation is \$300,000.

Example (3). The facts are the same as in example (2), except that N has an office in a foreign country which participates materially in the sales which are made through its U.S. office. Under section 865(e)(2)(B), income from N's sale of merchandise attributable to its U.S. sales office, but for which N's office in a foreign country participates materially, is not converted into U.S. source income. The taxable income which is attributable to N's U.S. sales office is not effectively connected for the taxable year with the conduct of a trade or business in the United States.

We suggest that if it is decided to issue new regulations under §865(e) that they include coverage of the above.

- **Required Technical Correction of §864(c)(4)(D)(i)**

Code §864(c)(4)(D)(i) provides an exception to ECI treatment when a foreign corporation pays dividends, interest, or royalties that are foreign source income in the hands of the foreign taxpayer recipient and the foreign "...taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b)), more than 50 percent of the total combined voting power of all classes of stock entitled to vote..."

Given the potentially expansive effect on this provision by the deletion of §958(b)(4), it would appear that there should be a technical correction proposed to make this sub-clause read:

(i) consists of dividends, interest, or royalties paid by a foreign corporation in which the taxpayer owns (within the meaning of section 958(a)), or is considered as owning (by applying the ownership rules of section 958(b) as in effect before its amendment by the Tax Cuts and Jobs Act), more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or

In order to reverse the effect of the deletion of §958(b)(4) by the Tax Cuts and Jobs Act within the regulations, Reg §1.864-5(d)(1) should be amended by adding the phrase "as in effect before its amendment by the Tax Cuts and Jobs Act (P.L. 115-97)", so that after amendment this subparagraph reads:

Dividends, interest, or royalties paid by a foreign corporation in which the nonresident alien individual or the foreign corporation described in paragraph (a) of this section owns, within the meaning of section 958(a), or is considered as owning, by applying the ownership rules of section 958(b) as in effect before its amendment by the Tax Cuts and Jobs Act (P.L. 115-97), at the time such items are paid more than 50 percent of the total combined voting power of all classes of stock entitled to vote.

- **Update of Reg §§1.864-5(d)(2)(iv) and (v)**

Reg §1.864-5(d)(2) provides an exclusion from ECI treatment for certain subpart F income of a CFC. One reference in this clause is to §954(c)(3) instead of §954(c)(2)(A). Another is to §954(c)(4) instead of §954(c)(3). These differences are due to subsequent reordering of the paragraphs within §954(c). Reg §§1.864-5(d)(2)(iv) and (v) should be amended to reflect these changes so that they would read:

(iv) Any income derived in the active conduct of a trade or business which is excluded under section 954(c)(2)(A), or

(v) Any income received from related persons which is excluded under section 954(c)(3).

- **Update of Reg §§1.864-5(b) and 1.864-6(b)**

Reg §1.864-5(b), which deals with the treatment of certain foreign source income, refers in subparagraph (1)(ii) to gain or loss on the sale of intangible personal property. The Tax Reform Act of 1986 (P.L. 99-514) inserted §865, which deals with sales of intangibles and causes §§865(d)(1)(A) and (e)(2) to govern the treatment of such transactions. P.L. 100-647, §1012(d)(10)(A), also amended §864(c)(4)(B) to eliminate coverage of such sales of intangibles by paragraph (4). Since §865(e)(2) can make such sales U.S. source and therefore covered by §864(c)(3), clause (ii) of Reg §1.864-5(b)(1) no longer has any relevance and should be deleted. In addition, Reg §§1.864-5(b)(3)(iii) and 1.864-6(b)(2)(i) should be amended to remove any reference to gains or losses on the sale or exchange of intangible personal property.

If the Treasury and IRS do issue modernized regulations, they should consider issuing a notice as soon as possible to alert taxpayers to any planned regulatory changes. This could be done in a manner similar to the notices issued for inversions (i.e. Notice 2014-52 and 2015-79) and anticipated regulations to implement certain TCJA changes. Such a notice could not only announce the planned amendments to the sourcing and ECI rules, but it could also alert taxpayers that ECI is subject to higher effective tax rates due to the branch profits tax (see §884) and the loss of deductions and credits and the open statute of limitations where no tax return has been filed (see §§882(c)(2) and 6501(c)(3)). Such notice(s) would strongly encourage MNCs to refrain from implementing or continuing profit shifting structures.

APPENDIX B

Section 863(b) including TCJA Amendment affecting Taxpayer-Produced Inventory Property under Paragraph (2)

We present below suggestions to change the existing regulations under §863(b), several of which are influenced by the TCJA amendment to source taxpayer-produced inventory property based solely on the basis of production activities.

- **Reg §1.863-3(c)(1)(i)(A)**

Amend the first three sentences of this subclause to read:

For purposes of this section, production activity means an activity that creates, fabricates, manufactures, extracts, processes, cures, or ages inventory including activities that constitute a substantial contribution (within the meaning of section 1.954-3(a)(4)(iv)) to the manufacture, production, or construction of personal property. See section 1.864-1. Subject to the provisions in section 1.1502-13 or paragraph (g)(2)(ii) of this section, the production activities that are taken into account for purposes of sections 1.863-1, 1.863-2, and this section are those conducted directly by the taxpayer and those conducted by the taxpayer's agents and related persons within the meaning of section 1.954-1(f).

- **Reg §1.863-3(c)(1)(i)(B)**

Amend the first sentence of this subclause to read:

Subject to the provisions of section 1.1502-13 and paragraph (g)(2)(ii) of this section, production assets include tangible and intangible assets owned directly by the taxpayer, the taxpayer's agents, and related persons (within the meaning of section 1.954-1(f)) that are directly used to produce inventory described in paragraph (a) of this section.

- **Reg §1.863-3(c)(1)(i)(C)**

The location of intangible production assets could be based on where the personnel are who perform relevant "substantial contribution" activities as described in Reg §1.954-3(a)(4)(iv)(b).

- **Consideration of Alternative Manner of Apportionment**

Given the need to modernize Reg §1.863-3 to reflect new business models such as those using contract manufacturers and activities constituting a "substantial contribution to the manufacture of personal property" as described in Reg §1.954-3(a)(4)(iv)(b), consideration should be given to an alternative method of apportionment when basing apportionment on the location of production assets is inappropriate. For example, perhaps allocations based on the location of personnel (whether employed by the taxpayer, its agents, or its related parties) involved in the Reg §1.954-3(a)(4)(iv)(b) production activities could be more appropriate in such situations. Or, the personnel costs of such production-involved persons could be used.

- **Reg §1.863-3(g)(3)**

To make clear the application of the §863 rules to a foreign partner in a partnership for purposes of determining effectively connected income, add the following **Example 3** to Reg §1.863-3(g)(3):

Example 3. Distribution in kind to foreign partner.

Assume the same facts as in Example 1 except that the partnership, instead of selling the widgets, distributes the widgets to A and B. B sells the widgets outside the United States through a sales office in its country of incorporation. In determining the effectively connected income earned by B on its gross profit from sales outside the United States, B is treated as conducting the activities of the partnership related to production of the distributed widgets. Accordingly, in applying this section, B is treated as owning its proportionate share of the partnership's production assets based upon its distributive share of partnership income. The source of gross income on the sale of the widgets is determined under section 863 and these regulations. B makes sales of inventory property produced in whole by the taxpayer within the United States and sold without the United States. Accordingly, income from B's sale of widgets shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities. As all production activities occur within, and all production assets are within the United States, all gross profits on B's sale of widgets are sourced within the United States.

To make clear the application of the §863 rules to a foreign partner in a partnership that uses a contract manufacturer for the physical production and makes a substantial contribution to production within the meaning of Reg §1.954-3(a)(4)(iv)(b), add the following **Example 4** to Reg §1.863-3(g)(3):

Example 4. Partnership makes substantial contribution to the production of inventory.

Assume the same facts as in Example 3 except that the partnership, instead of manufacturing widgets in the partnership's plant located in the United States, engages an unrelated contract manufacturer in another country for the physical manufacture of the widgets. The partnership through its facilities and personnel within the United States conducts the activities specified in Reg §1.954-3(a)(4)(iv)(b), thereby making a substantial contribution to the manufacture, production, or construction of the widgets. The partnership is accordingly considered to have produced the widgets sold. In determining the effectively connected income earned by B on its gross profit from sales outside the United States, B is treated as conducting the activities of the partnership related to production of the distributed widgets. The consequences described for Example 3 apply as well for this Example 4.

- **Anti-Abuse Rules in Connection with Certain Disregarded Entities**

Two of our articles (“Effects of New Sourcing Rule: ECI and Profit Shifting” in section III and “Sourcing Rule Change: Manufacturing and Competitiveness”, available respectively at <http://ssrn.com/abstract=3201365> and <http://ssrn.com/abstract=3296763>) discuss foreign producer sales into the U.S. The articles explain the double non-taxation result that some foreign producers will arguably have from selling foreign manufactured products into the U.S. through a disregarded entity (DRE) subsidiary (e.g. a limited liability company) that is treated as a sales branch of the foreign producer by the U.S. but as a separate taxpayer by the country of the producer.

Through such a mechanism, while profit attributable to the manufacturing functions conducted in the producer’s home country will be subject to tax in that country, the profits attributable to sales activities conducted within the DRE subsidiary may go untaxed by both the producer’s home country and the U.S. Further, where a foreign producer sets up a structure with multiple DRE subsidiaries, one of which performs contract manufacturing on a cost-plus basis and one or more other DRE subsidiaries perform other operational functions, including a U.S. sales office, the structure may avoid or minimize any tax on the residual profits after accounting for “routine” profits earned from manufacturing and other functions performed in countries where personnel are located.

Under territorial tax systems used in most producers’ home countries, there will typically be no home country taxation of the profits within any DRE subsidiary. Non-taxability by the U.S. of those same DRE subsidiary earnings is the result of the U.S. entity classification rules, the TCJA amendment to §863(b), and the taxpayer’s position that §865(e)(2) is ineffective in treating any income as being U.S. source and effectively connected income. Under the TCJA amendment, gross income from sales of property produced by a taxpayer in one country and sold in another is sourced solely in the location (or locations) where produced. As such, all gross income will be foreign source and will escape effectively connected income treatment despite the foreign producer being engaged in trade or business within the U.S. (See Appendix C for suggestions regarding §§865(e)(2) and (3).)

Setting up a hybrid structure like this to create double non-taxation will likely be relatively easy for many foreign producers selling into the U.S., including those owned by U.S.-based MNCs.

Considering the above, we strongly recommend that an anti-abuse rule that would override such structures be included in new regulations that reflect the TCJA amendment to §863(b). We propose the following language for such an anti-abuse rule:

Anti-abuse rule. If a foreign taxpayer

(i) sells or exchanges inventory property that it produced (in whole or in part) without the United States either within the United States or in a manner described in section 865(e)(2),

(ii) operates through one or more disregarded entity subsidiaries or other entities that are fiscally transparent within the meaning of section 301.7701-2(c)(2)(i) and (c)(1), and

(iii) earns profits that are taxed at a lower level of aggregate domestic and foreign taxation in comparison with the aggregate domestic or foreign taxation that would apply if the taxpayer had conducted all its operations directly and not through such subsidiaries or entities,

then solely for purposes of determining the source of income under Part 1 of Subchapter N, any such subsidiaries or entities will be treated as separate taxpayers.

There will be a lower level of aggregate domestic and foreign taxation if the taxpayer (including such subsidiaries and entities) pays an effective rate of tax that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized, or, if higher, under the laws of the country in which the highest percentage of production occurs, if, under the laws of such country, the entire income of the taxpayer (including such subsidiaries and entities) were considered derived by the corporation from sources within such country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country. This treatment of the entire income of the taxpayer will be modified to the extent that the applicable country provides an exemption to its resident taxpayers for profits properly allocable to *bona fide* foreign branches directly owned and operated by the resident (i.e. not including any foreign operations conducted through an entity separate from the taxpayer).

If a taxpayer enters into any transaction or structuring other than as described above with a principal purpose of applying the rules of this section to produce a material distortion of income source so as to achieve a lower level of aggregate domestic and foreign taxation than could be otherwise achieved in the absence of such transaction or structuring, the Commissioner may depart from the rules of this section as necessary to reflect appropriate sourcing of income.

Example.

Foreign corporation A (FC-A) is established in country A, a country that imposes a 20% tax on the worldwide profits of its corporate tax residents (subject to a foreign tax credit mechanism), but which exempts from tax dividends from foreign subsidiaries. FC-A has established wholly-owned subsidiaries in countries B (FC-B) and the United States (USLLC). FC-B conducts manufacturing within country B and is subject to country B's 22% tax on its profits. Country B imposes tax on its residents on a territorial basis by allowing an exemption for the profits of any foreign

branches. USLLC maintains an office in country C where it conducts management and other significant business functions. USLLC also maintains a sales office within the United States where it conducts sales activities that includes solicitation of orders, negotiation of contracts of sale, and other significant services necessary for the consummation of sales which are not the subject of a separate agreement between the seller and the buyer. USLLC, which holds all relevant intangible rights for product X, executes a contract manufacturing agreement with FC-B for a supply of X that USLLC will sell through its sales office within the United States to customers for use, disposition, or consumption both within and outside the United States. Under the contract manufacturing agreement, FC-B reports income and pays country B tax on a 5% cost-plus margin. Similarly, USLLC is taxed by country C on the basis of 5% of its locally incurred expenses. Within the United States, FC-A is considered the applicable taxpayer under the default rule of section 301.7701-3(b)(1) that treats USLLC as a disregarded entity. FC-A made an entity classification election under section 301.7701-3(c) for FC-B to treat it as a disregarded entity. FC-A takes the position under section 863(b) that it is producing inventory property outside the United States and selling it within the United States so that the source is based solely on the basis of production activities. FC-A takes the further position that section 865(e)(2) creates no income sourced within the United States. As a result, FC-A prepares and files Form 1120-F, "U.S. Income Tax Return of a Foreign Corporation", declaring no effectively connected income as defined in section 864(c).

If FC-A had directly conducted both FC-B's manufacturing operations and USLLC's sales activities, then country A would have imposed its 20% income tax on FC-A's worldwide income with a credit for foreign taxes paid. If the taxes imposed on FC-A were calculated under the laws of country B, a lower amount would be calculated due to the exemption for foreign branch profits allowed under country B's territorial tax system. As such, the effective rate of tax paid by FC-A and its two disregarded subsidiaries is compared to the tax that country A would have imposed.

If the effective rate of tax is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax which would apply to such income under the laws of country A, then in applying Part 1 of Subchapter N to determine the source of FC-A's gross income, FC-A, FC-B, and USLLC will all be treated as separate taxpayers. Such treatment will mean that with USLLC not itself manufacturing product X, section 863(b) will not apply and section 861(a)(6) and the regulations thereunder will apply to establish the source of income and ultimately the amount of effectively connected income under section 864(c).

APPENDIX C

Regulations Concerning §§865(e)(2) and (3)

Where a foreign producer (including foreign producers that are owned by U.S.-based MNCs) sells into the U.S. with title passing in the U.S., but is not engaged in any trade or business within the U.S., that producer shall have no U.S. taxation for two reasons. One is that a U.S. trade or business must exist for there to be effectively connected income (ECI). The other is that §863(b) as amended by the TCJA treats all income from such sales as being sourced at the location where production activities occur. The place of sale is not relevant.

Where such a foreign producer maintains a U.S. sales or other office (thereby being engaged in a U.S. trade or business) and the sales are attributable to that office, then §865(e)(2) overrides the §863(b) sourcing rule and provides that such sales (irrespective of where title might pass) will be U.S. source. With both a U.S. trade or business and U.S. source income, there will be ECI subject to taxation in the hands of the foreign producer. Certain definitions and limitations found in §864(c)(5) are made applicable by §865(e)(3).

Currently, there are no regulations issued under §§865(e)(2) or (3). As expressed in our article “Sourcing Rule Change: Manufacturing and Competitiveness”, dated November 5, 2018, and available at <http://ssrn.com/abstract=3296763>, there are several potential interpretations of how §§865(e)(2) and (3) could apply to any situation where a foreign manufacturer maintains a sales or other office within the U.S. As explained in our article, one of those potential interpretations is that the principles of §864(c)(5)(C) could be applied in a manner that would always cause zero U.S. source income, and thus zero ECI. This of course is an interpretation that is contrary to the legislative intent of §§865(e)(2) and (3), which were not amended by the TCJA. (See details in the article regarding legislative intent.)

In addition to this zero U.S. source income interpretation, the article also presents an interpretation based on the “properly allocable” language found in §864(c)(5)(C) and some legislative history. In brief, that history shows that Congress (i) did not want the U.S. to be used as a tax haven, and (ii) intended that only income generated in the U.S. would be subject to U.S. tax.

There is clearly ambiguity from these multiple interpretations that allows foreign taxpayers (and international tax advisors) to believe that the §865(e)(2) override is ineffective and allows zero ECI despite there being a U.S. office or other fixed place of business to which sales are clearly attributable. On the assumption that Treasury and the IRS agree that this “properly allocable” interpretation should prevail, we strongly recommend that regulations be issued under §§865(e)(2) and (3) that apply this “properly allocable” basis. This regulation would state clearly that the §863(b) treatment for foreign produced inventory property is overridden for any such property that is sold through a U.S. sales office, which of course is what makes §865(e)(2) applicable. It would further provide for application of the “properly allocable” standard as the means of determining the amount of U.S. source income. (The only exception would reflect the §865(e)(2)(B)

exception that applies when a foreign office of the taxpayer materially participates in the sale and the relevant property is sold for use, disposition, or consumption outside the U.S.)

See also the discussion in Appendix A concerning suggested changes to Reg §§1.864-4(b) and 1.864-6(c).

While we suggest these various changes to assure U.S. taxation of income that is “properly allocable” to the U.S. office or other fixed place of business, we do believe that there remains ambiguity within the relevant Code sections. As such, we believe that a legislative solution providing clarity is called for as detailed in our above-mentioned “Source Rule Change” article. That article commented:

The easiest correction would be to apply the section 864(c)(5)(C) limitation to foreign manufacturers based on pre-TCJA source rules. A simplifying approach could be to make the 50/50 method in reg. section 1.863-3(b)(1) the sole approach for applying the “properly allocable” standard.

APPENDIX D

Amendment of Reg §301.7701-1(a)(2) and/or Issuance of Revenue Ruling on Partnership Status for Certain Profit-Shifting Structures

Problem: Many MNC profit-shifting arrangements involve U.S. and foreign group members that conduct joint business activities using personnel, assets, and activities of two or more of the group members. Despite this reality of how many MNCs are operating, they take the position that such group members are totally independent of each other. Two examples will help demonstrate this.

First, consider an MNC that conducts a seamless worldwide business earning advertising revenues through a software platform, developed and expanded primarily by U.S. group members, that displays advertisements to the users of free services (e.g. email, search, etc.). While individual MNC group members record income from advertisers based on the advertiser's geographic location, U.S. group members conduct within the U.S. in one integrated operation for all applicable group members the day-to-day management and functions that allow the platform to operate and generate advertising revenues worldwide. These day-to-day management activities and functions are the guts of business operations and the actual activities that earn the profits.

Although zero- and low-taxed foreign group members, which license group IP or own it through cost sharing agreements, record their revenues and related expenses as if they were separate independent businesses, from a management and operational standpoint, they are not independently run businesses. Rather, they are part of one enterprise centrally run and conducted from within the U.S. Typically, such foreign group members do not have either the personnel or capabilities to conduct their own independent business or to even direct independent contractors acting on their behalf.

(Note that to keep the example simple, the above paragraph assumes a platform that is generating advertising revenues. The example could also cover platforms such as those that serve the gig economy and those that sell third-party produced products on either a buy-and-resell or commission basis.)

Second, using an unrelated Asian contract manufacturer, an MNC produces products for sale worldwide through a centrally managed supply chain. U.S. group members manage and conduct the bulk of the product development. Importantly, U.S. group members also manage and conduct the day-to-day production process itself, including functions such as:

- (i) Oversight and direction of production activities;
- (ii) Material selection, vendor selection, control of raw materials, work-in-process, or finished goods;
- (iii) Management of manufacturing costs or capacities;
- (iv) Control of manufacturing-related logistics; and
- (v) Quality control.

The MNC makes product sales through a number of sales channels. One channel is large volume sales made to major multinational customers and distributors around the world. Personnel within the U.S. not only set group-wide sales policy, but they may also be involved in maintaining relationships and negotiating sales terms with these major customers and distributors. Another channel involves sales made through a software platform used worldwide, for which U.S. group members conduct within the U.S. for all group members the day-to-day management and functions that allow the platform to operate and make sales. Despite this critical involvement of U.S. group members, sales to all foreign customers and distributors are recorded within zero- and low-taxed foreign group members. Such group members may provide local warehousing and other customer, logistical, and technical support, but they do not have the personnel or capability to independently conduct their own business. They are unable to direct the U.S. group members that are nominally acting as independent contractors, but that are in reality conducting crucial sales and production management, decision-making, and operational functions for the benefit of all group members making product sales.

(Note that this second example has been described as one that involves tangible inventory property. It could also involve the sale of intangible inventory property such as group-produced software.)

Although operationally the above two MNC group examples each conduct a globally seamless and centrally managed joint business, there is no overt partnership, joint venture, or similar contract governing the manner in which the group members conduct their joint business. Rather, each group member contracts separately with third parties (e.g. customers, raw material and component vendors, contract manufacturers, etc.) to give the legal appearance of separate and independently operating companies. Reflecting the reality that many functions benefiting zero- or low-tax foreign group members are being conducted by U.S. group members, intercompany service and similar agreements are executed that treat the U.S. group members as independent contractors and not as agents, partners, or joint venturers.

Solution: As covered in detail within the undersigned's article on unexpected partnership status, the above-described MNC profit shifting structures often create separate entities for federal tax purposes under Reg §301.7701-1(a)(2). Under the Reg §301.7701-3(b) default rules, these separate entities are characterized as partnerships.

It will be useful to contrast today's business models such as those described above with multinational businesses of decades ago that had a much different format than what has become so common today. Under this decades-old format, a U.S. parent company set group policies and provided oversight over its subsidiaries. However, these subsidiaries had a full complement of their own corporate officers (e.g. CEO, operations director, sales director, finance director, etc.) working from the subsidiary's facilities. The subsidiaries were truly standalone operations. Real on-the-ground management was an absolute necessity given the pre-internet communications and other technologies of the time (e.g. the telephone, telex, and fax machines). Enterprise software was in its infancy and even email did not emerge as a business communications device until the 1990s. *Given these independently run subsidiaries, there were not sufficient "joint business activities" that would ever cause any separate entity for tax purposes or a partnership. The issue simply didn't arise.*

Today, however, there is no longer any need for each subsidiary to have a full complement of its own corporate officers. The technology advances of the past several decades have allowed both a true centralized management and an isolation of specific and often narrow business functions that contribute to one worldwide business. The subsidiaries are each contributing to the group's worldwide business; they are no longer conducting their own independent businesses. The rise of supply chains where various functions occurring in different locations all contribute to one worldwide business is just one example. Another is the centralized management and operation of a worldwide internet-based business. Today's reality within many, if not most, MNCs is actual joint business activities and integrated management and operations.

Over the past several decades, the now commonly used centralized management of worldwide business has become the norm. It is easier, more cost effective, and commercially viable to manage and control a world-wide business using a management structure that relies on integrated technology and that directs personnel, assets, and activities located around the world toward a common goal. *The reality of this centralized management of group members and each member's sometimes narrow contribution to the group's worldwide business falls squarely within the applicable rules to create a separate entity and a partnership for tax purposes.*

Once the relationship between the U.S. and foreign group members is determined to be a partnership, there are several consequences.

- The U.S. and foreign group members are partners with the activities conducted and the assets used in that business considered to be those of the partnership and no longer the activities and assets of the respective partners. With the partnership carrying on a business through one or more U.S. offices, the foreign group member partners are similarly conducting a trade or business in the U.S. (§875(1)), which is the threshold test for applying the effectively connected income rules (§864(c)). Application of the ECI rules will be clear and unambiguous.
- Both partnership filing and §1446 withholding will apply.

Given both the important deterrence effect that partnership status will have on aggressive profit shifting structures and the important tool it represents for the government in its efforts to attack such structures, the authors recommend one, or, preferably, two actions. First, the Treasury and the IRS should make appropriate regulation amendments. Second, they should issue one or more revenue rulings that find separate entity and partnership status for relevant group members in certain profit shifting structures.

Amendment of Reg §301.7701-1(a)(2)

We suggest that Reg §301.7701-1(a)(2) be amended to read as follows:

A separate entity for federal tax purposes shall include a joint venture or other arrangement, whether or not evidenced by a contract or other written agreement, through or by means of which the participants carry on any business, financial operation, or venture. For example, a separate entity exists for federal tax purposes if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. On the other

hand, mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. A joint undertaking merely to share expenses does not create a separate entity for federal tax purposes. For example, if two or more persons jointly construct a ditch merely to drain surface water from their properties, they have not created a separate entity for federal tax purposes. Similarly, if an individual owner, or tenants in common, of farm property lease it to a farmer for a cash rental or a share of the crops, they do not necessarily create a separate entity for federal tax purposes. Participants, however, may create a separate entity for federal tax purposes if they actively carry on a trade, business, financial operation, venture, or any portion thereof and divide in any manner the profits or the products or other results thereof. Such a trade, business, financial operation, or venture may include, for example, (i) the joint production of inventory property, whether tangible or intangible, where the participants take in-kind or dispose of their shares of any property produced, extracted, or used, or (ii) the joint conduct of an internet platform-based business (e.g. giving advertisers access to platform users or providing cloud or other services including, for example, providing software and applications to users and acting as a sales agent or intermediary between users and third-party providers).

The above recommended language does two things. First, it adds examples that take into account modern business models using digital technologies. Second, it moves and expands the phrase “divide the profits therefrom”.

While the addition of modern business model examples is self-explanatory, the movement and expansion of the “profits” phrase deserves some explanation.

The first sentence of present Reg §301.7701-1(a)(2) reads:

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture *and divide the profits therefrom*. [Emphasis added.]

This sentence implies that for a separate entity to exist for federal tax purposes, the arrangement amongst the participants must have profits (or presumably losses) that are shared in some manner between them. Importantly, this implication is neither consistent with other Code and regulatory provisions nor with the historical regulations on which the current Reg §301.7701-1(a)(2) is based.

Regarding this inconsistency with other Code and regulatory provisions, first note §§761(a) and 7701(a)(2) that provide, with only minor language differences:

For purposes of this subtitle, the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate.

Focusing solely on this statutory language, joint production alone carried out by MNC group members reasonably falls within “any business, financial operation, or venture.” This is made 100% certain by §761(a)(2), which effectively states that an organization that is availed of “for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted” may elect to be excluded

from the application of all or part of subchapter K. If such an organization were not a partnership covered by subchapter K in the first place, it would not be necessary to have a specific provision allowing it to elect out of subchapter K. The point here, of course, is that an arrangement in which two or more participants solely produce inventory property with each participant taking its share in-kind will have no revenues from joint sales or services. As such, it will have no profit to share amongst the participants. Hence, without question, a separate entity for federal tax purposes can exist without the sharing of profits.

Note that even if this §761(a)(2) were not already a 100% certainty for joint production, for any MNC group members that also conduct joint sales, licensing, and service activities, these joint activities absolutely fall within these statutory provisions.

We stated above that there is also an inconsistency between the current regulation (Reg §301.7701-1(a)(2)) and the historical regulation on which the current regulation is based. This inconsistency directly involves the phrase “*divide the profits therefrom*”.

Specifically, to repeat, the first sentence of Reg §301.7701-1(a)(2) is:

A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and *divide the profits therefrom*. [Emphasis added.]

This placement of the “divide the profits” phrase makes it appear that the existence of profits and their being divided amongst the participants is a condition for there to be a separate entity for federal tax purposes. By contrast, the pre-1997 regulation (Reg §301.7701-3(a)) from which this language was taken reads, in part:

(a) In general. The term “partnership” is broader in scope than the common law meaning of partnership and may include groups not commonly called partnerships. Thus, the term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate. . . . Mere co-ownership of property which is maintained, kept in repair, and rented or leased does not constitute a partnership. . . . Tenants in common, however, may be partners if they actively carry on a trade, business, financial operation, or venture and *divide the profits thereof*. For example, a partnership exists if co-owners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent. [Emphasis added.]

This “divide the profits” phrase was previously only a means of distinguishing within the regulation *one example* of a situation involving co-ownership of property and did not modify the basic definition of a partnership, which was: “a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on.” This use in one example was, of course, fully consistent with the statutory definitions in both §§761(a) and 7701(a)(2), neither of which included any “divide the profits” requirement and neither of which was changed when the current regulation was promulgated in 1997.

By moving this “divide the profit” phrase to the first sentence in Reg §301.7701-2(a), it became in appearance a principal part of the definition of a separate entity for federal tax purposes, and thus narrowed the meaning of that term.

Was there any intention when the new 1997 the check-the-box regulations were issued to actually change the meaning, or at least the emphasis, of the definition of separate entity for federal tax purposes and narrow it through the addition of this “divide the profit” phrase?

We believe there was no such intention for any change that would narrow the meaning. First, of course, the statutory definition of “partnership” of many decades had not changed in either of §§761(a) or 7701(a)(2). Thus, there was no authority for any narrowing of the definition of “partnership” or the term “separate entity for federal tax purposes”, which is critical for defining the classification of entities under the new check-the-box regulations. Second, with the overall intention of the 1997 check-the-box regulations being simplification, the Treasury and IRS were likely just cleaning up the language of the reconfigured regulations without intending any change of meaning.

Interest in Partnership for Determining Distributive Share (§704(b))

As indicated earlier, the statutory definition of partnership, and by extension the definition of a separate entity for federal tax purposes, is very broad and includes organizations established under applicable local law and those established through contracts and the joint actions of the parties. The MNC group member relationships briefly described in the above examples are established through the operating joint activities of the parties and by other relevant factors, including verbal understandings, internal group policies, management lines of authority, and intercompany contracts — including any licensing and cost sharing agreements as well as any intercompany service agreements under which U.S. group members provide services to foreign group members. All of these will be factors in defining each participant’s interest in the separate entity for federal tax purposes, and thus each participant’s interest in the partnership for determining its distributive share under §704(b).

Consideration should be given to adding guidance and examples to Reg §1.704-1.

First, as a simplified approach that would be practical and easy to apply, the partnership profits (i.e., generally the combined profits of the joint business conducted by the group member partners) could be apportioned each year based on some appropriate factor(s) that each group member partner brings into the partnership. These factors could include, for example, the year’s average net assets, average personnel, average compensation, gross income from sales, etc. An additional factor that could often be relevant would be cumulative R&D expenses to reflect the contribution of intangibles.⁴ Where production occurs through use of a contract manufacturer and group personnel are performing the functions described in Reg §1.954-3(a)(4)(iv)(b), the personnel performing these manufacturing functions may be quite important and indicative of what each group

⁴ Note that where a partnership is found, any CSA that the partners may have executed would no longer be recognized since all relevant activities would be treated as occurring within the partnership, which is a single taxpayer. A CSA requires that there be two or more taxpayers.

member partner contributes to the partnership with net assets having little relevance. For many profit shifting structures, the zero- or low-taxed foreign group members will likely bring little or nothing into the partnership in the way of many of these factors.

A possible second approach would be to determine partner interest-in-the-partnership percentages as of the creation of the partnership. Those percentages would then be applied to the partnership profits for each subsequent year. Such percentages could be based on the original terms of the intercompany agreements executed among the group members when the partnership was created (i.e. likely at the same time that the group initiated its profit shifting structure). The terms of those various agreements (cost sharing agreement, any licensing agreements, intercompany service agreements, etc.) should reflect any IRS transfer pricing adjustments or advance pricing agreement that may have been obtained by the group.

A third approach would be to apportion the partnership profits by determining for each year each partner's interest-in-the-partnership, and thus its distributive share, based on the various written agreements between them (e.g. the cost sharing agreement, service agreements, etc.) and each partner's separate agreements with third parties (e.g. customers, contract manufacturers, suppliers, etc.).

Issuance of Revenue Rulings

We recommend that one or more revenue rulings be issued that prescribe when a joint business conducted by an MNC's group members shall create a partnership for tax purposes with those group members as the partners and their separate activities, which are limited to those activities that are part of the joint business, being treated as activities of the partnership. Such guidance for certain profit shifting structures should be a simple approach to demonstrating the government's resolve to fight artificial profit shifting structures.

One or more revenue rulings could also explore the issue of what group members' activities might be factually included within the joint business, and therefore included as activities of the partnership and not the separate activities of any partner. In addition to activities such as joint purchasing, production, and sales activities, research and development benefiting all group member partners would be included as well. As noted above in footnote 7, when so included, a ruling could provide that any cost sharing agreement signed by the group member partners would be no longer recognized for tax purposes.

Article 3 in footnote 3 provides detailed information from which a ruling may be drafted. The writers of this letter would be pleased to provide further guidance if it would be helpful.

APPENDIX E

Designate Certain MNC Profit-Shifting Structures as Listed Transactions

Many MNC profit-shifting structures exhibit three factors that suggest the existence of a U.S. trade or business, a partnership, and ECI. The three factors are:

- (a) Critical value-drivers performed predominantly by U.S. group members;
- (b) Extensive U.S.-located control and decision-making that far exceed what would be found in typical unrelated-party situations; and
- (c) A lack of capable foreign member management personnel and no CEO or similar position within the foreign group member who in substance runs that entity's worldwide business from an office outside the U.S.

We suggest that profit-shifting structures with these characteristics be designated as a “listed transaction” under Reg §1.6011-4(b)(2). If so designated, all parties will be on notice concerning the various penalty and disclosure requirements that apply to taxpayers that fail to report relevant income and pay tax. This should encourage some MNCs and their advisors to change or unwind existing profit-shifting structures as well as discouraging the creation of new structures. It should also discourage professional firms from pushing risky structures on existing and potential clients due to the disclosure and penalties applicable to any material advisor.

If for any reason it is determined that it is not possible to designate these structures as “listed transactions”, they could be designated as “transactions of interest” under Reg §1.6011-4(b)(6).

Whether or not it is decided to designate certain profit-shifting structures as listed transactions or transactions of interest, and to the extent that doing so would not require Congressional action, consideration should be given to providing administrative relief to unwind profit-shifting structures so as to encourage compliance and self-reporting of prior years' tax obligations on amended or late filings through abatement of penalties and/or other amounts that might otherwise be due.

APPENDIX F

Profit-Shifting Structures Implemented Following Inversions and Acquisitions by Foreign Acquirers

There have been and continue to be both inversion transactions and acquisitions of U.S.-based MNCs by foreign persons (including foreign acquisition vehicles owned by U.S. private equity funds). In all of these cases, following the inversion or acquisition, there are considerable tax-motivations to transfer U.S.-owned intangible assets to foreign group members and to establish profit-shifting structures that route profits to group members that are not CFCs.

Treasury and the IRS should consider issuing one or more notices to make clear that following any such inversion or acquisition the valuation of any transferred assets and the potential for ECI and earnings stripping will be priorities for examination. This could also be made a part of the LB&I Campaign program.

The following paragraphs include two examples. The first clearly illustrates post acquisition transfers of U.S. intangibles and related issues. The second, while not a tax case, illustrates how the acquisition of IP may be an important motivation for a foreign acquirer. In such cases, IRS examinations should be looking not only for undervaluation of IP transfers, but also for unrecorded transfers where acquirer group members merely start using the IP in their other products. This may have occurred in this Segway example.

Example 1 – Valeant Pharmaceuticals International

The first and perhaps best example is Valeant Pharmaceuticals International, a Canadian public company listed in the U.S. that is the result of a 2010 inversion. Interestingly, because Valeant was invited on July 30, 2015, to testify before the Senate Homeland Security and Affairs Permanent Subcommittee on Investigations (“PSI”), there is significant internal company information on tax avoidance involved in Valeant’s acquisitions of U.S. groups (including, for example, Salix Pharmaceuticals (2015) and Bausch and Lomb (2013)).⁵

The PSI Majority Staff Report,⁶ on pages 12 through 31 provides significant detail on how Valeant transferred intangibles owned by the acquired companies out of the U.S. shortly after each acquisition and set up profit-shifting arrangements. Not only is there the issue of valuation for transferred intangibles, which were transferred to an Irish subsidiary, but with the apparent lack of any change in the conduct of the acquired companies’ businesses, it is likely that the Irish company has significant taxable ECI following the transfer of these intangible assets.

⁵ All PSI hearing documents are available at <http://www.hsgac.senate.gov/subcommittees/investigations/hearings/impact-of-the-us-tax-code-on-the-market-for-corporate-control-and-jobs>

⁶ Available at <http://www.hsgac.senate.gov/download/?id=2C48E3A3-AFBE-43CB-8F05-0996EAAFCDF7>

Example 2 – Segway

Turning to another U.S. taxpayer, on September 9, 2014, Segway Inc. filed a trade complaint⁷ against a number of companies, most of which are Chinese. The basis for the trade complaint was that the respondents were importing products that infringed various Segway patents. Later in April 2015, it was announced that one of the Chinese respondents, Ninebot Inc., would acquire Segway.⁸ An interview with a co-founder of the acquirer stated:

The primary benefit of buying Segway is the patents. ... Ninebot is still young, as is Xiaomi [a major Chinese company partially funding Ninebot], so we can't successfully apply for many patents. Segway has the core patents for the self-balancing vehicle industry, so this acquisition will help us with our patents a lot.⁹

It seems likely that in many acquisitions like this, there may be not only undervalued transfers of intangibles to foreign acquirers, but there may be many undocumented transfers of designs, processes, and patent rights to foreign acquirers. IRS audit activity must identify such transferred intangibles and discourage such transfers through giving notice to applicable taxpayers of this priority.

The TechCrunch piece cited in footnote 8 commented regarding Xiaomi:

This marks the latest in a series of hardware and Internet of Things investments by Xiaomi, which has also given funding to companies like Misfit, Pebbles Interfaces, and iHealth Labs. Alliances with these startups can potentially help Xiaomi build its e-commerce unit, which, along with Internet services and hardware like its smartphones, form the core parts of its business.

⁷ Available at <http://www.itcblog.com/images/segwaycomplaintLR.pdf>

⁸ Shu, "Beijing-based Ninebot Acquires Segway, Raises \$80M From Xiaomi And Sequoia", TechCrunch (April 15, 2015), available at <http://techcrunch.com/2015/04/15/ninebot-segways-into-the-future/>.

⁹ Horwitz, "The founder of China's Ninebot says he bought Segway for the patents", TechinAsia (April 17, 2015), available at <https://www.techinasia.com/founder-chinas-ninebot-bought-segway-patents>.

APPENDIX G

Addition of Examples to the Manufacturing Branch Rule

Article 6 listed in footnote 3 notes how the manufacturing branch rule may apply to cause some gross income not caught by the ECI rules to be subpart F income. This treatment is not sufficiently clear in existing regulations and we suggest the following examples be added to the regulations as set out below.

In brief, assume that the facts underlying an MNC's profit shifting structure cause there to be an unanticipated partnership for U.S. tax purposes with U.S. group members and zero- or low-taxed foreign group members as partners. An explanation of why this may be likely is covered in Appendix B of this submission.

Although the MNC group uses one or more unrelated Asian contract manufacturers for the physical production of inventory property, the joint production activities of the group members conducted through the partnership meet the requirements of Reg §1.954-3(a)(4)(iv)(a) so that the inventory property sold by the partnership is considered manufactured, produced, or constructed by the partnership, and in turn by the CFC partners (Reg §1.954-3(a)(6)). As a result of this, the manufacturing branch rule of Reg §1.954-3(b)(1)(ii) applies. Note the last sentence of subparagraph (a) of Reg §1.954-3(b)(1)(ii), which reads:

... The provisions of this paragraph (b)(1)(ii) will apply only if the controlled foreign corporation (including any branches or similar establishments of such controlled foreign corporation) manufactures, produces, or constructs such personal property within the meaning of paragraph (a)(4)(i) of this section, or carries on growing or extracting activities with respect to such personal property.

Example 1 – All Manufacturing Performed in U.S.

Assume first that all of the partnership's production activities within the meaning of Reg §1.954-3(a)(4)(iv)(b) occur at offices and other facilities within the U.S. so that each CFC partner "carries on [through the partnership] manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized". Also assume that some portion of the partnership's sales are made for use, consumption, or disposition outside the U.S.

Before the TCJA and its amendment of §863(b), gross income from the production of inventory property within the U.S. and its sale outside the U.S. was sourced through one of several regulatory approaches that sourced a portion of the gross profit based on the taxpayer's production activities and the remainder based on the taxpayer's sales activities. After this TCJA amendment of §863(b), all (100%) of the gross profit is sourced at the location(s) of production.

Prior to the TCJA §863(b) amendment, the manufacturing branch rule is relevant for this Example 1, which involves production activities *solely* within the U.S. This is because the pre-TCJA partnership will have some foreign source income due to sales made outside the U.S. Because this foreign source gross income is not ECI and therefore could

not be directly taxable to a CFC partner, this foreign source income must be subjected to subpart F analysis. After the TCJA, with 100% of the gross profit based at the location of production, all gross profit under the facts of this Example 1 will be ECI, thereby causing subpart F and the manufacturing branch rule to no longer be relevant. (However, see Example 2 below with different facts where the manufacturing branch rule is relevant post-TCJA.)

With the partnership's manufacturing branch being located in the U.S., the manufacturing branch rule (Reg §1.954-3(b)(1)(ii)(b)) is applied to pre-TCJA years by comparing the effective tax rate on the relevant foreign source sales income with 30%. This 30% is the lower of 90% of, or 5 percentage points less than, the 35% U.S. tax rate that existed prior to the TCJA. If the actual taxes imposed are less than 30%, the manufacturing branch rule applies to relevant foreign sales income that would otherwise be caught by the Code §954(d)(1) definition of foreign base company sales income (FBCSI).

Note that not all foreign source income will be FBCSI. For example, say that the partnership (or a low-taxed foreign member partner) has a sales office in Singapore. In that case, inventory property sold for use, consumption, or disposition within Singapore would not be caught by the Code §954(d)(1) FBCSI definition. However, sales into nearby Malaysia where there is no sales office would be caught.

Example 2 – Manufacturing Performed Both Within and Without the U.S.

Assume now that 50% of the partnership's production activities for certain personal property occurs at offices and other facilities within the U.S. and 50% for that personal property occurs at offices in China adjacent to the facilities of an unrelated contract manufacturer. All activities performed by the partnership within the U.S. and in China are those described in Reg §1.954-3(a)(4)(iv)(b) and the partnership (and each CFC partner) is considered to have manufactured these items of personal property under Reg §1.954-3(a)(4)(iv)(a). The countries of incorporation of the CFC partners are zero- or low-taxed countries other than the U.S. or China. Through these U.S. and Chinese facilities, the partnership (and each CFC partner) "carries on manufacturing, producing, constructing, growing, or extracting activities by or through a branch or similar establishment located outside the country under the laws of which such corporation is created or organized". The partnership makes sales both within and outside the U.S.

With production activities being conducted both within and outside the U.S., under §863(b), whether prior to or following the above-mentioned TCJA §863(b) amendment, some portion of the gross income earned will be foreign source and, therefore, not ECI. With this foreign source income not being directly taxable ECI to any CFC partner, this foreign source income must be subjected to subpart F analysis.

The facts of this Example 2 make Reg §1.954-3(b)(1)(ii)(c)(3) applicable, which provides in part:

This paragraph (b)(1)(ii)(c)(3) applies to determine the location of manufacture, production, or construction of personal property for purposes of applying paragraph (b)(1)(i)(b) or (b)(1)(ii)(b) of this section where more than one branch or similar establishment of a controlled foreign corporation, or one or more branches or similar establishments of a controlled foreign corporation and the

remainder of the controlled foreign corporation, each engage in manufacturing, producing, or constructing activities with respect to the same item of personal property which is then sold by the controlled foreign corporation. ...

Without going into unnecessary detail, Reg §1.954-3(b)(1)(ii)(c)(3) includes a number of examples that cover various possible factual situations involving a CFC's production activities in multiple locations and the use of unrelated contract manufacturers.

Understandably, the examples consider situations involving one CFC with multiple operating locations and with its own personnel in each such location. None of the examples specifically consider a situation where multiple CFCs are conducting joint business operations in a manner that has created a partnership for tax purposes.

Simple Addition to Reg §1.954-3

Many MNC profit shifting structures implemented over the past two decades involve multiple group members (including both U.S. group members and CFCs) that conduct portions of a centrally managed and conducted worldwide business that is seamless to vendors, customers, and other third parties. As discussed in Appendix B, despite the lack of any partnership or joint venture agreement, the joint business activities conducted by these group members will often create a separate entity for federal tax purposes and a partnership under the Reg §301.7701-1 to -3 entity classification rules. Given such unanticipated partnerships, it is important to add clarity to Reg §1.954-3 such that taxpayers have increased guidance and the IRS has more specificity in taxing aggressive profit shifting structures that involve such jointly conducted businesses.

We believe that such clarity may be added to Reg §1.954-3 by adding the following example to Reg §1.954-3(a)(6):

Example. USP, a U.S. corporation, wholly owns CFC, a controlled foreign corporation organized under the laws of Country A. It has been determined that USP and CFC conduct their centrally managed worldwide business in a manner that creates a separate entity for federal tax purposes under section 301.7701-1(a)(2) and a partnership under the section 301.7701-3(b) default rules (Partnership Y). As a result of this partnership classification, all assets, personnel, and activities involved in the joint production and sales are considered the assets, personnel, and activities of Partnership Y and not the assets, personnel, or activities of either partner.

Through offices, facilities, and employees within the United States and Country B, Partnership Y performs activities within both countries that constitute the manufacture of Product P, within the meaning of paragraph (a)(4) of this section (including paragraph (a)(4)(iv)), if performed directly by CFC. Partnership Y, through its sales office in Country D, sells Product P to unrelated customers in Country E, a country in which Partnership Y maintains no sales branch.

CFC's distributive share of Partnership Y's sales income must be analyzed to determine whether it is foreign base company sales income taking into account all of section 1.954-3 including both the manufacturing exception of paragraph (a)(4) and the branch rules of paragraph (b).

APPENDIX H

Regulatory and Ruling Guidance Concerning Tax Treaties

A. Countering the Abusive Use of Tax Treaties

There has been significant profit shifting out of the U.S. and erosion of the U.S. tax base by both MNCs based in the U.S. and MNCs based abroad. Those based abroad include inverted MNCs, private equity acquisitions through foreign acquisition vehicles, and legitimate foreign-based groups. In some cases, such profit shifting has taken advantage of U.S. tax treaty provisions to reduce or eliminate withholding taxes or to apply treaty rules such as permanent establishment definitions in place of the lower-threshold standard of “engaged in trade or business within the United States”.

Brief Background on Common Situations Involving Taxpayer Abuse of Treaties

- Structures that Shift Business and Intangible Profits

With U.S.-based MNCs and some MNCs based abroad, especially inverted MNCs and private-equity structures, the foreign group member that is the “taxpayer” for U.S. tax purposes is a controlled foreign corporation (CFC) that is operating through one or more disregarded entity (DRE) subsidiaries. Some of those DRE subsidiaries are established in countries with which the U.S. maintains tax treaties. While such a DRE subsidiary is a bona-fide legal entity, fully respected as a separate taxable entity by its country of formation, it is treated solely for U.S. tax purposes as not existing and as a branch or division of its CFC owner, i.e., not an “entity”. Accordingly, the U.S. views all DRE subsidiary personnel, assets, and activities as being employed, owned, and conducted by the CFC.

As an example, assume that a U.S.-based MNC has established a CFC in a tax haven such as Bermuda. As that CFC has few or no employees of its own, it conducts business through subsidiaries in other countries for which check-the-box elections have been made to treat them as DRE subsidiaries. As a result of this structure, from a U.S. tax perspective, the only “taxpayer” is the Bermuda CFC. And that CFC operates through branches/divisions within the various countries where the DRE subsidiaries employ personnel, own assets, and conduct their respective operations. Those branches and divisions are not considered to be “entities” for U.S. tax purposes.

The authors of this submission have written a number of articles (see footnote 3) describing some structures through which MNCs have shifted business and profits from intangible assets out of the U.S. and into zero- and low-taxed group members, one of which may be a CFC while others are DRE subsidiaries of that CFC. An important focus of these articles has been the possible application of effectively connected income taxation to some portion of these shifted profits (§864(c)). Typically, these profit shifting structures not only shift profits out of the U.S. They also shift profits out of the foreign countries in which they operate through DRE subsidiaries. As a result, these structures normally bear very low levels of foreign taxation.

ECI taxation requires that the foreign taxpayer (i.e., the CFC in this case) be engaged in a trade or business within the U.S. (§864(b)). Where a tax treaty properly applies, this “trade or business within the U.S.” threshold is replaced by the permanent establishment definition included in the treaty. Further, where there is a permanent establishment and some amount of ECI is present, it is taxable at the normal corporate rate (pre-TCJA 35%, post-TCJA 21%). In addition, the branch profits tax (§884) applies at rate of 30% to the calculated dividend equivalent amount. If a tax treaty were to apply, then that 30% branch profits tax may be reduced or eliminated if the treaty specifies a lower rate or exemption.

- Structures Involving Interest, Royalties, and Dividends

DRE Subsidiaries. In addition to business income, DRE subsidiaries may license IP for use in the U.S. or loan money to U.S. persons, thereby earning U.S. source royalties and/or interest. A DRE subsidiary might also invest in the shares of non-related U.S. companies, thereby earning U.S. source dividends. Where a DRE subsidiary is established in a country with which the U.S. maintains a tax treaty, it might maintain that it should receive a reduction or elimination of the 30% withholding tax that applies under domestic law to these types of payments.

Other Foreign Entities. Foreign-based MNCs have aggressively eroded the U.S. tax base through interest and royalties charged to their U.S. operating subsidiaries. Concern about this has resulted in the TCJA adding new §59A, the base erosion minimum tax. This sort of base erosion by foreign-based MNCs normally does not involve either CFCs or DRE subsidiaries. It does, though, often involve routing interest and royalties through structures that arguably provide tax treaty benefits that reduce or eliminate the 30% U.S. withholding tax while avoiding any significant tax in the country of the treaty partner.

The U.S. enters into treaties to prevent double taxation; not to provide the opportunity for double non-taxation. Despite this, we see situations where taxpayers go through complicated structuring that arguably allows them to claim inappropriate treaty benefits. Most commonly, this means that they claim a treaty benefit from the U.S. while the relevant income is not taxed in the other treaty country on a normal resident basis. Thus, the sorts of profit-shifting structures and channeling of income from U.S. sources described above are normally only set up in treaty countries that offer special arrangements under which only a mere fraction (if any) of the normal resident tax is imposed. Well-known examples include Ireland and Luxembourg. Both have been documented as agreeing to special rulings and artificial practices that allow zero or little taxation far below the domestic effective corporate rates that apply to resident taxpayers. These special arrangements and low effective tax rates were not what U.S. treaty negotiators agreed to nor what the Senate thought it was ratifying.

The example within the first bullet point above assumes that the CFC is established in Bermuda, which maintains no tax treaty with the U.S. The CFC could also have been established in a country with which the U.S. maintains a tax treaty such as the U.K., Ireland, Switzerland, etc. In such cases, all (or virtually all) of the operating income is earned not within the CFC itself, but rather within the CFC’s DRE subsidiaries. As such, that operating income would not be reported in the tax returns that the CFC submits to its

own tax authorities in, say, the U.K. Further, due to the territorial tax systems and other exemptions and special rules employed by many countries, DRE subsidiary earnings actually distributed to the CFC typically go untaxed in the CFC's country of establishment.

Say that this CFC established in the U.K. claims that the activities of its DRE subsidiaries do not cause a permanent establishment in the U.S. under the U.S.-U.K. tax treaty. Or, say that the CFC has ECI and files a U.S. tax return to report profits earned within its DRE subsidiaries, but claims that the U.S.-U.K. tax treaty reduces the 30% branch profits tax to 5%. With the relevant income for which the CFC is claiming benefits under the U.S.-U.K. tax treaty not being reported within any U.K. tax filings, it is inappropriate for treaty benefits to be granted.

It could also occur that a DRE subsidiary claims tax treaty benefits based on the *U.S. treaty with the country of establishment of the DRE subsidiary*. This could occur, for example, where the DRE subsidiary claims that it has no permanent establishment within the U.S. or that the 30% branch profits tax should be reduced or exempted. It could also occur where the DRE subsidiary claims treaty reductions in the 30% U.S. withholding tax on dividends, interest, and royalties. Often, such claims involve taxpayer abuse that seeks benefits not anticipated by either U.S. treaty negotiators or the Senate.

The second bullet point also notes the inappropriate use of tax treaties by foreign-based MNCs to erode the U.S. tax base. CFCs and DRE subsidiaries are often not involved in such claims for treaty benefits.

Discussion

Fiscally Transparent Entities. Our belief is that such above-described abusive situations involving a CFC taxpayer that conducts business operations or records transactions (including investments, loans, licenses, etc.) through DRE subsidiaries should never receive any treaty benefits, either at the CFC level or at the level of any DRE subsidiary. (The only exception might be where the DRE subsidiary is incorporated within the same country as the CFC for solely non-tax reasons and tax on a normal resident basis is being paid to that country by both the CFC and the DRE subsidiary.) Almost without exception, schemes involving CFCs and DRE subsidiaries have been carefully crafted to avoid or significantly reduce both foreign and U.S. taxation by carefully working to fall within mismatches between the tax laws of the U.S. and one or more other countries to arbitrage their tax systems.

Both Fiscally Transparent and Non-Fiscally Transparent Entities. Sometimes, carefully crafted structures involve a special arrangement between a foreign entity (whether a DRE subsidiary or any non-fiscally transparent foreign entity) and the foreign tax authorities that allows these companies to pay tax at zero or discounted rates not allowable absent such agreement. In these cases, since the home country is not taxing the foreign entity on a true resident basis, no reduction in or elimination of U.S. withholding taxes or other tax treaty benefits (e.g. the application of business profits provisions and reduction in or elimination of the §884 branch profits tax) should be permitted.

The remainder of this Appendix F provides specific recommendations on regulation amendments or guidance that could be provided in a revenue ruling that would disallow these inappropriate treaty benefits.

Fiscally Transparent Entities—Treaty Benefits Other than Reduction or Elimination of Withholding Taxes

With respect to **non-withholding tax treaty benefits** claimed where CFC and DRE subsidiary structures are involved, the terms of tax treaties and current law allow the IRS to disallow these benefits. The IRS may directly enforce these rules against such abusive arrangements.

For the CFC, the fact that its tax filings made to its home country will exclude all income, deductions, credits, etc. recorded within its DRE subsidiaries means that it cannot be a resident for purposes of the tax treaty under the last sentence of Article 4, paragraph 1. This sentence in the February 17, 2017, version of the U.S. Model Income Tax Convention reads:

... This term does not include any person whose tax is determined in that Contracting State on a fixed-fee, “forfait” or similar basis, or *who is liable to tax in respect only of income from sources in that Contracting State or of profits attributable to a permanent establishment in that Contracting State.* [Emphasis added.]

For the DRE subsidiaries, as indicated earlier, a DRE subsidiary is not recognized as an “entity” for U.S. tax purposes. As such, the IRS may simply refuse to grant any relevant tax treaty benefits under the treaty between the U.S. and the country of establishment of the DRE subsidiary on the basis that the DRE subsidiary cannot be a “person” for purposes of that treaty under Article 3, and therefore not a treaty “resident” under Article 4.

Needed: Regulatory and/or ruling guidance concerning the non-applicability of tax treaty benefits in the above circumstances.

Fiscally Transparent Entities—Treaty Benefits for Withholding Taxes

With respect to **reduction in or elimination of withholding taxes**, Reg §1.894-1(d) provides relevant rules.¹⁰

A critical first rule relevant to these abusive arrangements is that the regulation provides for DRE subsidiaries at paragraph (d)(3)(i) an expansive definition of “entity”. As such, this definition overrides the lack of any “entity” (as explained in the section immediately above) that otherwise occurs under the domestic U.S. rules.

Needed: A tax abuse rule that will override this paragraph (d)(3)(i) definition.

A critical second rule is the regulation’s concept of “derived by a resident” found in paragraph (d)(1). T.D. 8889 (65 F.R. 40993-41000, 2000) consciously included this

¹⁰ Note that Reg §1.894-1(d) by its terms only applies to certain withholding taxes. These rules have no applicability to the non-withholding tax treaty benefits discussed immediately above.

concept as the mechanism to determine qualification for withholding tax treaty benefits. In brief, T.D. 8889 included the following explanation:

Commentators suggested that the term subject to tax in the proposed and temporary regulations was ambiguous and could be misinterpreted. Commentators suggested that the term subject to tax could be interpreted as requiring that an actual tax be paid rather than requiring an exercise of taxing jurisdiction by the applicable treaty jurisdiction, whether or not there is an actual tax paid. Commentators suggested that such an interpretation would lead to anomalous results, for example, in cases when the applicable treaty jurisdiction provides an exemption from income for U.S. source dividends under its tax laws.

The IRS and Treasury agree that the term subject to tax could cause unintentional confusion and that a more direct and simpler way of ensuring that an item of income is subject to the taxing jurisdiction of the residence country is to determine if the item of income is derived by a resident of a treaty jurisdiction. The concept of derived by a resident is a more useful surrogate for the concept of subject to the taxing jurisdiction of the residence state, the necessary prerequisite for the grant of treaty benefits on an item of income.

Because of this expansive “derived by a resident” rule that is totally divorced from any actual or potential tax liability or inclusion in taxable income, special rulings, administrative practices, and other artificial means have expanded to meet the needs of MNCs intent on creating complex structures that shift profits and/or erode the U.S. tax base, making full use of the U.S. treaty network in the process. The light shed on this from the LuxLeaks disclosures¹¹ and other sources has been extensive.

Needed: A tax abuse rule that will override this “derived by a resident” test and replace it with a “subject to tax” test.

In considering the above, the Treasury and IRS should keep in mind that the MNCs that create these CFC and DRE subsidiary structures have voluntarily-made check-the-box elections. The applicable taxpayer (i.e., the CFC) was not coerced into making these elections for its subsidiaries. Rather, these elections are made only after careful group-wide study of how to maximize profit-shifting and base erosion benefits. This being the case, it is more than reasonable that such taxpayers must live with the consequences of their actions. The above recommendations are appropriate and in no way excessive.

Abuse Not Involving Fiscally Transparent Entities

Many foreign MNCs abuse the U.S. treaty network on interest and royalty flows. One of the clearest examples is described in the Majority Staff Report titled “Impact of the U.S. Tax Code on the Market for Corporate Control and Jobs” issued on July 30, 2015, by the Permanent Subcommittee on Investigations (Committee of Homeland Security and Governmental Affairs) under the Chairmanship of Rob Portman. The example involves Valeant Pharmaceuticals International, Inc., a Canadian-based pharmaceutical MNC that resulted from a 2010 inversion.

¹¹ Available at: <https://www.icij.org/project/luxembourg-leaks/explore-documents-luxembourg-leaks-database>

The following is from pages 25-30 of this 2015 Majority Staff Report:

In connection with the Bausch & Lomb acquisition, Valeant pushed down \$2.4 billion of the acquisition debt from its foreign affiliates to a Delaware subsidiary (VPI-Delaware), thereby creating a stream of deductible interest payments that have significantly reduced Bausch & Lomb's U.S. tax base. Specifically, Valeant-Canada issued an aggregate \$7.3 billion in debt financing from third-party banks. Valeant-Canada then made an interest-free loan of \$3.1 billion to a Luxembourg subsidiary, Biovail International S.a.r.l., which in turn made an interest-bearing loan (at 6%) of \$2.4 billion to VPI-Delaware.

The result of this intercompany lending is evident in the rise in Valeant- U.S.'s tax-deductible, outbound related-party interest payments. In the two years preceding the Bausch & Lomb acquisition, Valeant's U.S. group made an average of \$219,000 per quarter in related-party interest payments. In the first full year following the acquisition, those payments swelled to \$59.9 million per quarter—a 273-fold increase. To date, Valeant's U.S. group has made \$320.2 million in interest payments on the Bausch & Lomb acquisition debt to Biovail International S.a.r.l. and projects another \$375 million in interest payments through the first quarter of 2017; those payments will continue through the life of the loan. *The interest payments are fully deductible in the U.S. and subject to no U.S. federal withholding taxes. Only a portion of the interest income received by Valeant in Luxembourg is taxable—at single-digit tax rates.*

[Emphasis added and footnotes omitted.]

As if this insult to the U.S. taxation system were not enough, the following is from page 30 of the 2015 Majority Staff Report:

Valeant structured the Salix acquisition debt in a manner that will significantly reduce Valeant's U.S. tax base. Valeant-Canada raised \$15.2 billion in debt financing from third parties to support the Salix acquisition. Valeant then made an interest-free loan of \$16.5 billion to VFL (Luxembourg). VFL, in turn, made six intercompany loans totaling \$16.5 billion to VPI Delaware at an average interest rate of approximately 6.2%. Valeant projects that, from the first quarter of 2015 through the first quarter of 2017, it will make \$1.67 billion in interest payments on the Salix debt to VFL; those payments are scheduled to continue until the maturity date of each loan (ranging from 2021 to 2025). To date, Valeant's interest payments on the Salix acquisition debt have been fully deductible in the U.S. and subject to no U.S. federal withholding taxes. Only a portion of the interest income received by Valeant in Luxembourg is taxable—at single-digit tax rates. [Emphasis added and footnotes omitted.]

This sort of artificial arrangement (very low effective tax rate in Luxembourg due to deemed interest deductions on an interest-free loan), and most likely a special ruling from the Luxembourg tax authorities, is abusive. The group's international planning likely results in a double deduction of interest and little or no effective taxation ever of the interest income in either Luxembourg or in Valeant's home country of Canada.

Needed: Regulatory and/or ruling guidance to help taxpayers and the IRS identify abusive situations where tax treaty coverage should no longer be appropriate given that the relevant income is not being taxed in the treaty country of residence in the same manner as a normal resident would be taxed.¹²

As an indication of the basis for such broad guidance, the following is from T.D. 8999 (67 F.R. 40157-40162, 2002). The initial sentence refers to abuses involving domestic reverse hybrids.

... The overall effect of these transactions, if respected, would be (1) a deduction under U.S. law for the “outbound” payment of an item of income, (2) the reduction or elimination of U.S. withholding tax on that item of income under an applicable treaty, and (3) the imposition of little or no tax by the treaty partner on the item of income. This result is inconsistent with the expectation of the United States and its treaty partners that treaties should be used to reduce or eliminate double taxation of income. The legislative history of section 894(c) supports this analysis. Congress specifically expressed its concern about the use of income tax treaties to manipulate the inconsistencies between U.S. and foreign tax laws to obtain similar benefits. See H.R. Conf. Rep. No 220, 105th Cong., 1st Sess. 573 (1997); Joint Committee on Taxation, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), at 249 (December 17, 1997). The approach adopted by these regulations also is consistent with the U.S. view that contracting states to an income tax treaty may adopt provisions in their domestic laws to prevent inappropriate use of the treaty. ...

As further encouragement of the critical need for additional regulatory and/or ruling guidance in this general area, it may be noted that Reg §1.894-1(d) was promulgated soon after the issuance of the new check-the-box entity classification rules and without anticipating how MNCs would aggressively utilize them to shift profits outside the U.S. and erode the U.S. tax base.

¹² Interestingly, while guidance is needed to cover the entire U.S. treaty network, it should be noted that the U.S.-Luxembourg treaty states in Article 24 (Limitation on Benefits):

10. Notwithstanding the other provisions of this Article, Luxembourg holding companies, within the meaning of the Act (loi) of July 31, 1929 and the Decree (arrete grand-ducal) of December 17, 1938, or any subsequent revision thereof, *or such other companies that enjoy a similar special fiscal treatment by virtue of the laws of Luxembourg*, are not residents. [Emphasis added.]

Considering the low level of taxation within Luxembourg due to the interest free loan with a deemed interest deduction, this provides a strong treaty-based position to deny coverage of this tax treaty for abusive transactions. Consideration should be given to expanding rulings and other Treasury and IRS materials to provide guidance that takes actual tax treaty provisions such as this into account.

T.D. 8889 and T.D. 8999 expanded Reg §1.894-1 in 2000 and 2002, focusing principally on structures that would involve income flows to “real” foreign persons. Further, they were expressly limited to treaty benefits applicable to withholding taxes and domestic reverse hybrids. T.D. 8889 commented:

These regulations apply with respect to all U.S. income tax treaties regardless of whether such treaties contain partnership provisions, unless the competent authorities agree otherwise. As with the proposed and temporary regulations, the final regulations address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business. *The IRS and Treasury may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions*, with respect to the income of fiscally transparent entities, particularly where a conflict in entity classification exists. [Emphasis added.]

After these regulations were issued, abusive profit shifting and base erosion by U.S. MNCs involving foreign hybrid entities grew quickly, if not exponentially, especially after the 2004 Jobs Act repatriation incentive. Despite this quick growth, detailed study and knowledge only started to become public in 2010 when the Staff of the Joint Committee on Taxation issued its report titled “Present Law and Background Related to Possible Income Shifting and Transfer Pricing” (JCX-37-10), dated July 20, 2010, for a Ways and Means Committee public hearing. This public hearing and the JCT’s report, along with other hearings and investigative reporting in subsequent years (Google, Microsoft, Apple, Caterpillar, etc.), laid clear the aggressive and artificial nature of many of the structures that our MNCs eagerly adopted.

In short, it’s time for regulatory and ruling guidance that eliminates inappropriate treaty benefits both within the framework of Code §894(c) and broader.

B. Comments on the Application of Articles 5 and 7 to Foreign Treaty Residents

Where a resident of a treaty country maintains a permanent establishment within the U.S. that is involved in the sale of property produced by the resident outside the U.S., §863(b) provides for full foreign source treatment of all income. However, an application of §§865(e)(2) and 864(c)(5)(C) could find that income that is “properly allocable” to the U.S. office or other fixed place of business is U.S. source and therefore effectively connected income under domestic law. In Appendix C, we have suggested that new regulations under §§865(e)(2) and (3) provide for application of the “properly allocable” standard as the means of determining the amount of U.S. source income.

Where a resident of a treaty country

- (i) directly through its own employees,
- (ii) through an agent,
- (iii) through the actions of other persons (whether related or unrelated) acting as putative independent contractors who direct or otherwise conduct the business of the resident, thereby being *de facto* agents, or
- (iv) through a partnership (including an LLC or other entity treated as a partnership for tax purposes),

maintains a permanent establishment within the U.S. that is involved in the production of property or the management, maintenance, or other material operation of an internet platform or other business mechanism through which the resident earns gross income, then §863(b) or Reg §1.861-4(b)(1) applies to create some amount of U.S. source income that will be effectively connected income under domestic law. Item (iii) in the above listing reflects the suggested expansion of Reg §1.864-2 in Appendix A included in the “Clarity of Engaged in Trade or Business within the United States” bullet point.

Suggestions made within several Appendices of this submission focus on both abuses connected with profit shifting structures and the possible effects from the TCJA amendment of §863(b). Under that amendment, taxpayer-produced inventory property is sourced solely at the location where production activities take place. These suggestions highlight two treaty issues that we discuss below. One is the suggested clarification of a U.S. trade or business to include actions by another person who conducts within the U.S. important portions of the business of a foreign taxpayer. This raises the permanent establishment definition in Article 5 as an issue. The second issue is what effect amended §863(b) might have in relation to Article 7 regarding taxation of business profits.

It should be noted that many profit shifting structures that move profits into low-taxed foreign group members use entities that are not treaty country residents. A review of publicly available information about a number of major household-name multinationals would show that many have used tax haven and other countries with which the U.S. maintains no tax treaty, or have placed group members in treaty-partner countries where the group member is not resident in that country under the applicable treaty (e.g. non-tax-resident Irish company). In such cases, domestic U.S. tax law will apply. Section A of this Appendix H included suggestions concerning treaty coverage in a number of situations, including foreign group members that are disregarded entities and claim treaty benefits. This seems an area that is ripe for some regulatory amendments, rulings, or other approaches that will prevent inappropriate and abusive uses of tax treaties.

- **Clarification of U.S. trade or business**

This submission in Appendix A included adding the following at the end of paragraph (a) of Reg §1.864-2 to clarify the definition of “engaged in trade or business within the United States”:

The term also includes the performance of activities within the United States (for example the purchasing or production of products, the substantial contribution to the manufacturing of personal property within the meaning of section 1.954-3(a)(4)(iv)(b), the sale of products, the maintenance and management of an internet-based platform through which sales are made or advertising or other internet based service revenues are earned, the rental or licensing of intangibles, etc.) by another person (whether related or not and including activities performed under any independent contractor service agreement or agency) who conducts all or any material portion of these activities or manages the commercial risks thereof for or on behalf of any taxpayer when the taxpayer itself has insufficient personnel or capacity to conduct all or any material portion of its business or manage the commercial risks thereof. The actual conduct

and activities of the persons will be decisive rather than any contractual label or description that provides, for example, that the person conducting the activities or managing the commercial risk is an independent contractor providing a service.

This language is meant to make clear that where a person conducts activities within the U.S. for the benefit of a foreign person where those activities represent the conduct of that foreign person's business, then that foreign person will have a U.S. trade or business. The essence of this is that the person conducting the activities is a *de facto* agent of the foreign person.

Where the foreign person is a resident of a treaty country, then the permanent establishment article in the treaty will apply. Assuming that Treasury issues an amendment to Reg §1.864-2(a) that clarifies that these activities conducted by other persons will cause a U.S. trade or business, then some guidance regarding the interaction of this clarification and the Article 5 definition of permanent establishment would be useful.

The first point is what guidance to provide. A second point is where to provide that guidance.

Regarding the first point, where the person conducting the activities within the U.S. is factually managing risks and/or making decisions on the foreign person's business within the meaning of Reg §1.864-2(a) as clarified, thereby creating a *de facto* agent, then guidance should provide that that will equate to exercising "an authority to conclude contracts that are binding on the enterprise". Doing so will allow paragraph 5 of Article 5 to apply, which will cause the foreign person to have a permanent establishment.

As for where to provide that guidance, perhaps something could be issued under §894(b). Or, perhaps it's possible to add guidance within Reg §1.864-2. Alternatively, guidance could be included within the explanation section of the Treasury Decision within which the amendment is made adding the clarifying language to Reg §1.864-2(a). A revenue ruling, of course, is another possibility. Another would be to add this guidance to the Technical Explanation of the 2016 U.S. Model Tax Convention when that Technical Explanation is eventually issued. If the issuance of this Technical Explanation is not expected anytime soon, perhaps there could be an amendment of the Technical Explanation for the 2006 U.S. Model. Needless to say, it seems important that this guidance be provided at the same time or shortly after expanded Reg §1.864-2 is adopted.

- **Effect of amended §863(b)**

It was indicated above that an application of §§865(e)(2) and 864(c)(5)(C) could find that income "properly allocable" to the U.S. office or other fixed place of business is U.S. source and therefore effectively connect income under domestic law. This is also true where Reg §1.861-4(b)(1) applies to create some amount of U.S. source income. In these cases, the applicable tax treaty's Business Profits article could limit the amount of taxable effectively connected income to the

profits that are attributable to the permanent establishment. The 2016 U.S. Model Tax Convention provides in Article 7, paragraphs 1 and 2:

1. Profits of an enterprise of a Contracting State shall be taxable only in that Contracting State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, **the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 of this Article may be taxed in that other Contracting State.**

2. For the purposes of this Article, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 of this Article are **the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.**

[Emphasis added.]

The above from the 2016 U.S. Model reflects the Authorized OECD Approach (AOA). Some tax treaties entered into by the U.S. have been more consistent with the pre-AOA OECD approach and the still current approach in the U.N. Model Double Taxation Convention. Paragraph 2 in both the pre-AOA version and the current U.N. version is:

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment **the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.** [Emphasis added.]

One other item worthwhile noting is the following from page 22 of the 2006 U.S. Model Technical Explanation:

The "attributable to" concept of paragraph 2 provides an alternative to the analogous but somewhat different "effectively connected" concept in Code section 864(c). In effect, **paragraph 2 allows the United States to tax the lesser of two amounts of income: the amount determined by applying U.S. rules regarding the calculation of effectively connected income and the amount determined under Article 7 of the Convention.** That is, a taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match. [Emphasis added.]

For domestic law purposes where §865(e)(2) and §864(c)(5)(C) are applicable, we suggested in Appendix A including in Reg §1.864-6(c)(2) (and perhaps in new regulations under §865(e)(2) as well) an effective definition of “properly allocable” through referencing the methods included in paragraph (b) of Reg §1.863-3 as in effect for taxable periods beginning on or before December 31, 2017.

In addition, we suggested that an Example (4) be added to Reg §1.864-4(b) to make clear that there could be U.S. source income earned by a foreign person from the management, maintenance, or other operation of an internet platform through which the foreign person earns gross income. An Example (5) was suggested to make this clear as well for production activities. In both these cases, whether through the operation of §865(e)(2) and §864(c)(5)(C) or Reg §1.861-4(b), there would be some amount of taxable effectively connected income under domestic law.

Where a treaty applies to a foreign person, then that person has the option to apply Article 7 of the treaty to arrive at a lower amount of taxable profits.

Since the initiation over twenty years ago of the check-the-box rules in Reg §§301.7701-1 through -3, hybrid entities have become an increasingly important part of the tax landscape. Recently proposed regulations such as those under the §267A hybrid rules and the §904(d) foreign branch income have included relevant rules concerning hybrids entities and disregarded transactions including disregarded payments.

Focusing again on tax treaties, Article 7 analyses required under the AOA may recognize certain dealings between a permanent establishment and other parts of the enterprise. These dealings may or may not follow actual transactions conducted by entities that are disregarded entities for U.S. tax purposes. Considering this complicated landscape, it seems sensible to provide some guidance of how the AOA and pre-AOA approaches would work when dealings exist between a permanent establishment and other parts of the enterprise. Perhaps this could be done through several examples where the same set of facts is analyzed under both the pre-AOA and the AOA.

We suggest that consideration be given to providing such guidance in a revenue rule and/or in the future Technical Explanation that would be issued in connection with the 2016 U.S. Model Tax Convention.